SUGGESTED ANSWERS

TO

QUESTIONS

SET AT THE

INSTITUTE'S EXAMINATIONS

MAY, 2000 – NOVEMBER, 2008

A COMPILATION

FINAL EXAMINATION

PAPER – 3 : ADVANCED AUDITING

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA
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FOREWORD

I am extremely happy to know that Board of Studies has planned and taken many constructive measures to help students prepare a better strategy to excel in the examinations. These are in the forms of *compilation of question papers, suggested answers, comments on the questions* etc. All these exercises aim at simplifying the fundamentals and covering the relevant areas of the main subjects. Questions and Answers are formulated in a manner so that the students get maximum benefit from the study materials. This will leave no scope for any ambiguity and confusion.

The compilation of the subjects for the final examination includes **Advanced Accounting, Advanced Audit, Corporate Law and Secretarial Practices, Management Accounting and Financial Analysis, Cost Management, Management Information and Control System.** They cover the questions and answers upto November, 2008 examinations.

These effective measures by the Board of Studies are worth commending and deserve a special mention. I sincerely congratulate the entire team.

June, 2009 | **CA. Uttam Prakash Agarwal**
New Delhi | **President, ICAI**

FOREWORD

Suggested Answers to the questions set in the Institute's earlier examinations serve as a useful practice manual for the students. As these suggested answers are available separately for different examinations, it was felt that a classified compilation would be useful for the purpose of examination preparation. It is very handy to have suggested answers of recent examinations that are compiled subject-wise covering different examinations. The compilation series of various subjects are meant for addressing this requirement of the students. This readily helps to understand the type of questions set in the Institute's examination and standards answers thereof.

The compilation in the subject of "Advanced Auditing" of Final Course is the latest edition to the above mentioned series and covers a period of 9 years – May, 2000 to November, 2008 and contains compilation of suggested answers of 18 examinations.

The compilation is divided into Seventeen Chapters and Appendix. Questions and answers are arranged in a logical sequence in each chapter and as far as possible in the same order in which these are presented in the study material.

I complement the Board of Studies for updating the compilation upto November 2008. I am sure that you will find this compilation a useful tool while preparing for the examinations.

June, 2009
New Delhi

CA Jaydeep Narendra Shah
Chairman, Board of Studies

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1
STANDARDS ON AUDITING

Question 1

Comment on the following:

"The auditors need not review accounting policies unless there is a change in the basis of accounting". (8 marks)(Final May 2000)

Answer

The auditor while conducting an audit should critically examine' the accounting policies adopted by the client and test them for conformity with the accounting standards and recommendations of the Institute. The Companies Act, 1956, as well as many other statutes require that the financial statements of an enterprise should give a true and fair view of its financial position and working results. This requirement is implicit even in the absence of a specific statutory provision to this effect. However, what constitutes a 'true and fair' view has not been defined either in the Companies Act, 1956 or in any other statute. The pronouncements of the Institute seek to describe the accounting principles and the methods of applying these principles in the preparation and presentation of financial statements so that they give a true and fair view. The 'Preface to the Statements of Accounting Standards' issued by the Institute in 1979 states as under:

"While discharging their attest function, it will be the duty of the members of the Institute to ensure that the Accounting Standards are implemented in the presentation of financial statements covered by their audit reports. In the event of any deviation from the Standards, it will be also their duty to make adequate disclosures in their reports so that the users of such statements may be aware of such deviations."

In cases where no pronouncement of the Institute exists, the auditor should examine the acceptability of the said accounting policy. The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements. The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated. It is also quite clear that there is no single, list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgement by the management of the enterprise. SA 200A on "Objective and Scope of the Audit of Financial Statements", requires auditor to determine whether the relevant information is properly disclosed in the financial statements by considering the judgements that management has made in preparing the financial statements; accordingly, the auditor assesses the selection and consistent application of accounting policies, the manner in which the information has been classified, and the adequacy of disclosure.

Thus, the auditor should determine himself as to whether or not the said treatment is consistent with the basic principles of accounting. Therefore, it would not be correct to state that the auditor need not review the accounting policies unless there is a change in the basis of accounting.

Question 2

Briefly describe the auditor's responsibility regarding subsequent events.

(10 marks) (Final May 2001)

Answer

Subsequent Events and Auditor's Responsibility: When the auditor draws up his audit plan, checking of subsequent events is an important audit procedure irrespective of the level of test checks employed for checking of the transactions during the year. In fact more detailed check is normally required for subsequent events to confirm certain assertions contained in the financial statements, e.g., the payment made by debtors after the close of accounting period would confirm that outstanding debtors on the date of the balance sheet date have been realised. SA 560 on "Subsequent Events" establishes standards on the auditor's responsibility regarding subsequent events. SA 560 on "Subsequent Events" states that the term "subsequent events" refers to significant events occurring between the balance sheet date and the date of the auditor's report. AS 4 on " Contingencies and Events Occurring after the Balance Sheet Date" deals with all those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company and by the corresponding approving authority in the case of any other entity. As per AS 4, events can be identified as adjustable events which provide further evidence of conditions that existed at the balance sheet date; and, non-adjusting events are those which are indicative of conditions that arose subsequent to the balance sheet date. SA 560 lays down that the "auditor should consider the effect of subsequent events on the financial statements and on the auditor's report". When the time between the close of the year-end and the adoption of accounts is about to take place, examination of subsequent events gains more importance.

SA 560 further requires that the auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified. The procedures to identify events that may require adjustment of, or disclosure in, the financial statements would be performed as near as practicable to the date of the auditor's report and ordinarily include the following:

(i) Reviewing procedures that the management has established to ensure that subsequent events are identified.

(ii) Reading minutes of the meetings of shareholders, the board of directors and audit and executive committees held after the balance sheet date and inquiring about matters discussed at meetings for which minutes are not yet recorded.

(iii) Reading the entity's latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports.

(iv) Inquiring, or extending previous oral or written inquiries, of the entity's lawyers concerning litigation and claims.

(v) Inquiring of management as to whether any subsequent events have occurred after the balance sheet date which might affect the financial statements.

When the auditor becomes aware of events which materially affect the financial statements, the auditor should consider whether such events are properly accounted for in the financial statements. When the management does not account for such events that the auditor believes should be accounted for, the auditor should express a qualified opinion or an adverse opinion as appropriate.

Question 3

Briefly describe how an auditor can use the work of an expert. (8 marks) (Final Nov 2001)

Answer

Using the Work of an Expert: SA 620 on, "Using the Work of an Expert" discusses the auditor's responsibility in relation to, and the procedures the auditor should consider in, using the work of an expert as audit evidence. The auditor has to first determine the need to use the work of an expert considering the materiality of the item, its nature and complexity. It would be necessary in cases of valuation of certain types of assets, determining the physical condition of the assets like minerals, actuarial valuation of gratuity, determining work in progress in case of construction contracts, etc. Generally, the auditor's education and experience enable him to be knowledgeable about business matters in general, but he is not expected to have the expertise of a person trained for, or qualified to engage in, the practice of another profession or occupation, such as an actuary or engineer.

When the auditor plans to use the expert's work as audit evidence, the auditor is required to assess skill and competence of the expert, his objectivity and, finally, evaluate the work done by him. So first of all, the auditor should satisfy himself as to the expert's skills and competence by considering the expert's:

- professional qualifications, license or membership in an appropriate professional body, and
- experience and reputation in the field in which the evidence is sought.

However, when the auditor uses the work of an expert employed by him, he will not need to inquire into his skills and competence. The auditor should also consider the objectivity of the expert. Finally, when the auditor intends to use the work of an expert, he should examine evidence to gain knowledge regarding the terms of the expert's engagement and such other matters as:

- the objectives and scope of the expert's work,
- a general outline as to the specific items in the expert's report,
- confidentiality of the expert's work, including the possibility of its communication to third parties.
- the expert's relationship with the client, if any,
- confidentiality of the client's information used by the expert.

The auditor should seek reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial information, by considering:

- the source data used,
- the assumptions and methods used and, if appropriate, their consistency with the prior period,
- the results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of his audit procedures, and
- the auditor should also satisfy himself that the substance of the expert's findings is properly reflected in the financial information.

The auditor should consider whether the expert has used source data which are appropriate in the circumstances. The procedures to be applied by the auditor should include :

- making inquiries of the expert to determine how he has satisfied himself that the source data are sufficient, relevant and reliable, and
- conducting audit procedures on the data provided by the client to the expert to obtain reasonable assurance that the data are appropriate.

The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. The auditor does not have the same expertise and, therefore, cannot always challenge the expert's assumptions and methods. However, the auditor should obtain an understanding of those assumptions and methods to determine that they are reasonable based on the auditor's knowledge of the client's business and on the results of his audit procedures.

If after performing all these procedures the auditor concludes that the work of the expert is not consistent with the information in the financial statements or that it does not constitute sufficient appropriate audit evidence, the auditor should express a qualified, disclaimer or an adverse opinion. In other cases, the opinion has to be unqualified. If while giving his report the auditor considers it appropriate to disclose the identity of the expert, he should obtain his prior consent.

Question 4

Write short notes on the following:

(a) Financial indications to be considered for evaluating the assumption of going concern

(4 marks) (Final Nov 2001)

(b) Auditor's responsibilities regarding comparatives. (4 marks)(Final Nov 2003)

(c) Sampling Risk (4 marks)(Final May 2006)

(d) Reporting on a compilation engagements (4 marks)(Final Nov 2006)

Answer

(a) Financial Indications and Going Concern: SA 570 on "Going Concern", aims to establish standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the preparation of the financial statements. The following are the financial indications be considered:

- Negative net worth or negative working capital.
- Fixed-term borrowings approaching maturity without realistic prospects or renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets.
- Adverse key financial ratios.
- Substantial operating losses.
- Substantial negative cash flows from operations.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Difficulty in complying with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

- ♦ Entering into a scheme of arrangement with creditors for reduction of liability.

(b) Auditor's responsibilities regarding comparatives: SA 710, "Comparatives", establishes standards on the auditor's responsibilities regarding comparatives.

The auditor responsibilities laid down are as under:

(i) The auditor should determine whether the comparatives comply, in all material respects with the financial reporting framework relevant to the financial statements being audited. Further, the auditor should obtain sufficient appropriate audit evidence that the corresponding figures meet the requirements of the financial reporting framework.

(ii) When the comparatives are presented as corresponding figures, the auditor's report should not specifically identify comparatives because the auditors opinion is on the current period financial statements as a whole, including the corresponding figures.

(iii) When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification in the audit report is:

(a) unresolved and results in a modification of the auditor's report regarding the current period figures, the auditor's report should also be modified regarding the corresponding figures; or

(b) unresolved, but does not result in a modification of the auditor's report regarding the current period figures, the auditor's report should be modified regarding the corresponding figures.

In such circumstances, the auditor should examine that appropriate disclosures have been made or if appropriate disclosures have not been made, the auditor should issue a modification report on the current period financial modified with respect to the corresponding figures included therein.

(iv) When the prior period financial statements are not audited, the incoming auditor should state in the auditors report that the corresponding figures are unaudited.

(c) Sampling Risk: Sampling Risk arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure. The auditor is faced with sampling risk in both tests of control and substantive procedures as follows:

(a) Tests of Control:

(i) *Risk of Under Reliance*: The risk that, although the sample result does not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.

(ii) *Risk of Over Reliance*: The risk that, although the sample result supports the auditor's assessment to control risk, the actual compliance rate would not support such an assessment.

(b) Substantive Procedures:

(i) *Risk of Incorrect Rejection*: The risk that, although the sample result supports the conclusion that a recorded amount balance or class of transactions is materially mis-stated, in fact it is not material mis-stated.

(ii) Risk of Incorrect Acceptance: The risk that, although the sample result supports the conclusion that a recorded amount balance or class of transactions is no materially mis-stated, in fact it is materially mis-stated.

The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial statements then either the risk of under reliance or the risk of incorrect rejection.

Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

(d) Reporting on a compilation engagements: The report on compilation engagements should ordinarily, be in the following layout:

(i) Title – The title of the report should be "Accountants Report on compilation of un-audited financial Statements."

(ii) Addressee: The report should ordinarily be addressed to the appointing authority.

(iii) Identification of the financial information also noting that it is based on the information provided by the management.

(iv) When relevant, a statement that the accountant is not independent of the entity;

(v) A statement that the Management is responsible for:

- Completeness and accuracy of the underlying data and complete disclosure of all material and relevant information to the accountant;
- Maintaining adequate accounting and other records and internal controls and selecting and applying appropriate accounting policies;
- Preparation and presentation of financial statements or other financial information in accordance with the applicable laws and regulation, if any;
- Establishing controls to safeguard the assets of the entity and preventing and detecting frauds or other irregularities.

- * Establishing controls for ensuring that the activities of the entity are carried out in accordance with the applicable laws and regulations and preventing and detecting any non-compliance.

(vi) A statement that the engagement was performed in accordance with the Auditing and Assurance Standards.

(vii) A statement that the neither an audit nor a review has been carried out and that accordingly no assurance is expressed on the financial information.

(viii) A paragraph, when considered necessary, drawing attention to the disclosure of material departures from the identified financial reporting framework.

(ix) Date of the report

(x) Place of signature

(xi) Accountant's signature.

Question 5

Explain what is meant by " Written Representations" and indicate to what extent an auditor can place reliance on such representations. *(6 marks)(Final May 2002)*

Answer

Written Representation : The management is responsible for the appropriate preparation and presentation of financial information. Thus it is quite natural that during the course of audit, management would be required to make several representations on various matters relating to financial statements. These representations may be made by the management either in orally or in writing to the auditor. For example, the auditor may ask the management to confirm about the existence of contingent liabilities and disclosure thereof, etc. In other words, representation by management constitutes acknowledgement by the management about its responsibility for the preparation and approval of the financial information. A written representation may either take the form of a letter from the management or letter by auditor outlining auditor's understanding and confirmation of the same.

Extent of Reliance: SA 580, "Written Representations", states that management representations whether obtained orally or in writing constitute audit evidence and establishes standards for evaluating the same. SA 580, requires that the auditor may rely upon the management's representation, preferably in writing, as a sort of information or evidence to consider and if the representations relate to matters which are material to financial information, Further, the auditor should:

(a) seek corroborative evidence from sources inside or outside the entity.

(b) evaluate whether the representations made by the management appear reasonable and consistent with other audit evidence obtained, including other representations; and

(c) consider whether the individuals making the representations are expected to be well informed on the matter.

However, it must be note that representations by the management cannot be the substitute for other audit evidence that the auditor could reasonably expected to be available. For example, a representation by the management as to existence, quantity and cost of inventories is not substitute for adopting audit procedures regarding verification and valuation of inventories. If a representation by management is contradicted by other evidence, the auditor should examine the circumstances and, when necessary, reconsider the reliability of other representations made by the management as well.

Question 6

Answer the following in brief:

(a) How can an Auditor identify Related Parties? *(8 marks)*

(b) How does an Auditor evaluate the work of an Expert? *(8 marks)(Final Nov 2002)*

Answer

(a) Identification of Related Parties: The duties of an auditor with regard to reporting of transactions with related parties as required by Accounting Standard 18 are given in SA 550 on Related Parties. As per SA 550 on, "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties. Since it is the management, which is primarily responsible for identification of related parties, SA 550 requires that to identify names of all known related parties, the auditor may carry out the following procedures:

(i) review his working papers for previous years for names of known related parties;

(ii) review the entity's procedures for identification of related parties;

(iii) inquire as to affiliation of directors, key management personnel and officers with other entities, etc.;

(iv) review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a list of principal shareholders from the share register;

(v) review memorandum and articles of association, minutes of the meetings of shareholders and the board of directors and its committees and other relevant statutory records such as the register of directors' interests;

(vi) inquire of other auditors such as internal auditor, special auditors appointed under any statute, cost auditors, and concurrent auditors of the entity as to their knowledge of additional related parties and review the report of the predecessor auditors;

(vii) review the entity's income tax returns and other information supplied to regulatory agencies; and

(viii) review the joint venture and other relevant agreements entered into by the entity.

In addition, the auditor needs to be alert for transactions which appear unusual in the circumstances and which may indicate the existence of previously unidentified related parties. Examples include–

- Transactions which have abnormal terms of trade, such as, unusual prices, interest rates, guarantees, and repayment terms.
- Transactions which lack an apparent logical business reason for their occurrence.
- Transactions in which substance differs from form.
- Transactions processed in an unusual manner.
- High volume or significant transactions with certain customers or suppliers as compared with others.
- Rendition of services without receipt or provision of management services at no charge.

Finally, the auditor should also obtain a written representation from the management concerning the completeness of information provided regarding the identifications of related parties.

(b) Evaluating the Work of an Expert: The duties of an auditor regarding using the work of an expert are contained in SA 620 "Using the Work of an Expert". The auditor has to first evaluate the skills and competence of the expert and also his objectivity. When the auditor decides to use the work of an expert, he should examine evidence to gain knowledge regarding the terms of the expert's engagement and such other matters like:

- the objectives and scope of the expert's work,
- a general outline as to the specific items in the expert's report,
- confidentiality of the experts work, including the possibility of its communication to third parties,
- the expert's relationship with the client, if any, and
- confidentiality of the client's information used by the expert.

The auditor should also seek reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial information. This can be done by considering:

- the source data used,

- the assumptions and the methods used and, if appropriate, their consistency with the prior period,
- the results of the experts work in the light of the auditor's overall knowledge of the business and of the results of his audit procedures, and
- the auditor should also satisfy himself that the substance of the expert's findings are properly reflected in the financial information.

The auditor should also consider whether the expert has used source data that is appropriate in the circumstances. This can be done by making inquiries to determine that the source data is sufficient, relevant and reliable and also conducting audit procedures on the data provided by the client to the expert to obtain reasonable assurance that the data are appropriate. The auditor should obtain an understanding of those assumptions and methods to determine that they are reasonable based on the auditor's knowledge of the client's business and on the results of his audit procedures. The standard also provides that in case the auditor comes across any inconsistency, the auditor may discuss the matter with the client and the expert and, may employ additional procedures including possibly engaging another expert may also assist the auditor in resolving the inconsistency.

Question 7

"There should be sufficient liaison between a principal auditor and other auditors". Discuss the above statement and state in this context the reporting considerations, when the auditor uses the work performed by other auditor. *(8 marks)(Final Nov 2002)*

Answer

SA 600 on "Using the work of another auditor" lays down the procedure to be applied in situations where a principal auditor reporting on the financial statement of the entity uses the work of another independent auditor. SA 600 contemplates coordination between auditors and requires that there should be sufficient liaison between the principal auditor and the other auditor. For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

The other auditor, knowing the context in which his work is to be used by the principal auditor, should coordinate with the principal auditor. For example, by bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements. Similarly, the principal auditor should advice the other auditor on any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

When considered necessary, the principal auditor may require the other auditor to answer a detailed questionnaire regarding matters on which the principal auditor requires information for discharging his duties. The other auditor should respond to such questionnaire on a timely basis.

The reporting considerations laid down by SA are as under:

When the principal auditor concludes, based on his procedures, that the work of the other auditor can not be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.

In all circumstances, if the other auditor issues, or intends to issue, a qualified report, the principal auditor should consider whether the subject of the qualification is of such nature and significance, in relation to the financial information of the entity on which the principal auditor is reporting, that it requires a qualification in the principal auditor's report.

Question 8

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

(a) While commencing the statutory audit of B Company Limited, the auditor undertook the risk assessment and found that the detection risk relating to certain class of transactions cannot be reduced to acceptance level. (4 marks)

(b) While auditing accounts of a public limited company for the year ended 31st March 2003, an auditor found out an error in the valuation of inventory, which affects the financial statement materially – Comment as per auditing and assurance standards.

(5 marks)

(c) At the statutory audit of TOR Limited, the physical verification of fixed assets was conducted. However the auditor was not able to confirm the existence of valuables and important machinery. In this connection, the auditor obtained a certificate from the management to prove its existence and value and accepted the same blindly without any further procedures. (4 marks) (Final Nov 2003)

Answer

(a) Assessment of Risk and Acceptable Level

SA 315 and SA 330 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" and "The Auditor's Responses to Assessed Risks" establishes standards on the procedures to be followed to obtain an understanding of the accounting and internal control systems and on audit risk and its components: inherent risk, control risk and detection risk. SAs 315 and 330 requires that the auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. "Detection risk" 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. The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures. When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. The auditor should use his professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. If it cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate.

(b) Errors in Valuation of Inventories and Auditor's Responsibilities

SA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements", requires that if circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate. SA 240 also requires that the auditor should consider the implications of the misstatement in relation to other aspects of the audit, particularly, the reliability of management representations. Further, SA 320 also requires that in such circumstances, the auditor should consider requesting the management to adjust the financial information or consider extending his audit procedures. If the management refuses to adjust the financial information and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should express a qualified or adverse opinion, as appropriate. In the instant case, the auditor has detected the material errors affecting the financial statements; the auditor should communicate his findings to the management on a timely basis, consider the implications on true and fair view and also ensure that appropriate disclosures have been made.

(c) Management Representation

The physical verification of fixed assets is the primary responsibility of the management. The auditor, however, is required to examine the verification programme. Further, he must satisfy himself about the existence, ownership, procession and valuation of fixed assets. It appears from the facts of the case that the auditor has not been able to verify either existence or valuation of significant fixed assets despite conducting physical verification audit procedure himself. Ultimately, he accepted the certificate from the management without performing further procedures. As per SA 580, "Written Representations", representation by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. Thus, a representation by management as to the existence of valuables and machinery is no substitute for adopting normal audit procedures regarding verification of valuable and important machinery. If the auditor is unable to obtain sufficient appropriate audit evidence that he believes will be available, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter and the auditor may express a disclaimer of opinion.

Question 9

"There should be sufficient liaison between a principal auditor and other auditors". Discuss the above statement and state in this context the reporting considerations, when the auditor uses the work performed by other auditor. *(8 marks) (Final Nov 2003).*

Answer

SA 600 on, "Using the Work of Another Auditor", lays down the procedure to be applied in situations where a principal auditor reporting on the financial statement of the entity uses the work of another independent auditor. SA 600 contemplates coordination between auditors and requires that there should be sufficient liaison between the principal auditor and the other auditor. For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor. For example, by bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the timetable for audit of the component, etc. He should ensure compliance with the relevant statutory requirements. Similarly, the principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

When considered necessary, the principal auditor may require the other auditor to answer a detailed questionnaire regarding matters on which the principal auditor requires information for discharging his duties. The other auditor should respond to such questionnaire on a timely basis.

The reporting considerations laid down by SA are as under:

When the principal auditor concludes, based on his procedures, that the work of the other auditor can not be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.

In all circumstances, if the other auditor issues, or intends to issue, a qualified report, the principal auditor should consider whether the subject of the qualification is of such nature and significance, in relation to the financial information of the entity on which the principal auditor is reporting, that it requires a qualification in the principal auditor's report.

Question 10

What are your views on the following?

An auditor of Sagar Ltd. was not able to get the confirmation about the existence and value of certain machineries. However, the management gave him a certificate to prove the existence and value of the machinery as appearing in the books of account. The auditor accepted the same without any further procedure and signed the audit report. Is he right in his approach?

(5 marks) (Final Nov 2004)

Answer

Validity of Written Representation: The physical verification of fixed assets is the primary responsibility of the management. The auditor, however, is required to examine the verification programme adopted by the management. He must satisfy himself about the existence, ownership and valuation of fixed assets. In the case of Sagar Ltd., the auditor has not been able to verify the existence and value of some machinery despite the verification procedure followed in routine audit. He accepted the certificate given to him by the management without making any further enquiry. As per SA 580, when representation relate to matters which are material to the financial information, then the auditor should seek corroborative audit evidence for other sources inside or outside the entity. He should evaluate whether such representations are reasonable and consistent with other evidences and should consider whether individuals making such representations can be expected to be well informed on the matter. "Written Representations" cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. If the auditor is unable to obtain sufficient appropriate audit evidence that he believes would be available regarding a matter, which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter. Therefore, the approach adopted by the auditor is not right.

Question 11

(a) What are 'Initial Audit Engagements'? (2 marks)

(b) In an initial audit engagement the auditor will have to satisfy about the sufficiency and appropriateness of 'Opening Balances' to ensure that they are free from misstatements, which may materially affect the current financial statements. Lay down the audit procedure, you will follow in cases (i) when the financial statements are audited for the preceding period by another auditor; and (ii) when financial statements are audited for the first time. (7 marks)

(c) If, after performing the procedure, you are not satisfied about the correctness of 'Opening Balances'; what approach you will adopt in drafting your audit report in two situations mentioned in (b) above? (7 marks) (Final Nov 2004)

Answer

(a) Initial Engagement – Opening Balances: As per SA 510 'Initial Engagements - Opening Balances' initial audit engagements mean

(i) When the auditor is engaged to carry out the audit of financial statements of an entity for the first time; or

(ii) When the financial statements of the entity for the preceding period were audited by another auditor.

The situation mentioned in (i) above is obviously when the auditor is appointed to take up the audit for the first time or no audit was carried out of the financial statements of the entity for the immediately preceding period. The situation mentioned in (ii) above arises whenever there is a change of auditor.

(b) (i) **Financial Statements Audited by Another Auditor – Audit Procedure:**

(a) Ordinarily the current auditor can place reliance on the closing balances contained in the audited financial statements of the preceding period. Sufficient audit evidence will be obtained for verifying opening balances, which are closing balances of the earlier period by perusing the copies of the audited financial statements.

(b) If during the performance of audit for the current period the possibility of misstatements in opening balances is indicated, some indirect audit evidence can be obtained as part of the audit procedures performed during the current period. For example, the collections and payments of opening balances in the accounts of debtors and creditors respectively during the current period will provide evidence as to their existence, correctness and valuation at the beginning of the period.

(ii) **Audit of Financial Statements for the First Time – Audit Procedure:** When the audit of financial statements is being conducted for the first time, the auditor has to perform auditing procedures to obtain sufficient appropriate audit evidence. Since opening balances represent effect of transaction and events of the preceding period and accounting policies applied in the preceding period, the auditor need to obtain evidence having regard to nature of opening balances, materiality of the opening balances and accounting policies. Since it will not be possible for auditor to perform certain procedures, e.g., observing physical verification of inventories, etc. the auditor may obtain confirmation, etc. and perform suitable procedures in respect of fixed assets, investments, etc. The auditor can also obtain management representation with regards to the opening balances.

(c) **Drafting Audit Report:** If after performing the laid down procedure in SA 510, "Initial Engagements - Opening Balances", the auditor is not satisfied in either of the above situations, he should, as appropriate express a qualified opinion or disclaimer of opinion. At times, it is also likely that the auditor opines that the profit and loss account is qualified but balance sheet is found to be unqualified. If the opening balances contain misstatements which materially affect the financial statements for the current period and the effect of the same is not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.

Question 12

Enumerate the 'Basic Elements of Audit Report' as enshrined in SA 700.

(8 marks) (Final Nov 2004)

Answer

Basic Elements of Auditor's Report: As per SA 700, "The Auditor's Report on Financial Statements", the auditor's report includes the following basic elements:

1. ***Title**:* It is appropriate to use the term "Auditor's Report' in the title so as to distinguish the same from other reports, e.g., Board of Directors' Report, etc.
2. ***Addressee**:* Ordinarily, the auditor's report is addressed to the authority appointing the auditor.
3. ***Opening or Introductory Paragraph**:* The auditor's report should identify the financial statements of the enterprise that has been audited including the date of and period covered by the financial statements. This introductory paragraph must state that the preparation of financial statements is the responsibility of the management and that the auditor's responsibility is to express an opinion based on audit.
4. ***Scope Paragraph**:* The auditor's report should describe the scope of the audit stating that the audit was conducted in accordance with auditing standards generally accepted in India. It must also lay down briefly the work performed by the auditor and the constraints involved in discharge of his attest function.
5. ***Opinion Paragraph**:* This paragraph is mainly devoted for expression of opinion as to whether the financial statements give a true and fair view and whether they comply with the statutory requirements.
6. ***Date of Report**:* The date of an auditor's report on the financial statements is the date on which the auditor signs the report expressing an opinion on the financial statements. The date of report informs the reader that the auditor has considered the effect on the financial statements and on the report of the events and transactions of which the auditor became aware and that occurred up to that date. Since the auditor's responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the report earlier than the date on which the financial statements are signed or approved by management.
7. ***Place of Signature***: The report should name specific location, which is ordinarily the city where the audit report is signed.
8. ***Auditor's Signature***: The report should be signed by the auditor in his personal name. Where the firm is appointed as the auditor, the firm name should also be mentioned. The proprietor or partner signing the report should also mention his membership number.

Question 13

Write a short note on Responsibility of Joint Auditors (4 marks) (Final Nov 2004)

Answer

Responsibility of Joint Auditors: SA 299 on, "Responsibility of Joint Auditors" deals with the professional responsibilities, which the auditors undertake in accepting such appointments as joint auditors. The responsibilities of joint auditors, as a rule are no different from the responsibilities of individual auditors as enumerated in the Companies Act, 1956. Main features of the said SA are discussed below:

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

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

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

(b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.

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

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

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

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

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

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

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

Question 14

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

(a) The Managing Director of the Company has committed a "Teeming and Lading" Fraud. The amount involved has been however subsequently after the year end deposited in the company. (4 marks)

(b) The accountant of C Ltd. Has requested you, not to send balance confirmations to a particular group of debtors since the said balances are under dispute and the matter is pending in the court. (4 marks) (Final May 2005)

Answer

(a) Fraud Committed by Managing Director: The Managing Director of the company has committed a "Teeming and Lading" fraud. The fact that the amount involved has been subsequently deposited after the year end is not important because the auditor is required to perform his responsibilities as laid down in SA 240 , "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements". First of all, as per SA 240, the auditor need to perform procedures whether the financial statements are materially misstated. Because an instance of fraud cannot be considered as an isolated occurrence and it becomes important for the auditor to perform audit procedures and revise the audit risk assessment. Secondly, the auditor need to consider the impact of fraud on financial statements and its disclosure in the audit report. Thirdly, the auditor should communicate the matter to the Chairman and Board of Directors. Finally, in view of the fact that the fraud has been committed at the highest level of management, it affects the reliability of audit evidence previously obtained since there is a genuine doubt about representations of management. Finally, the auditor shall have to report under CARO, 2003 indicating the nature and amount involved in respect of fraud noticed during the year.

(b) External confirmation Requests: SA 505, "External Confirmations", establishes standards on the debtor's use of external confirmation as a means of obtaining audit evidence. It requires that the auditor should employ external confirmation procedures in consultation with the management. The auditor may come across certain situations in which the management may request him not to seek external confirmation from certain parties because of dispute with the debtors, etc. The management, for example, might make such a request on the grounds that due to a dispute with the particular debtor, the request for confirmation might aggravate the sensitive negotiations between the entity and the debtor. In such cases, when an auditor agrees to management's request not to seek external confirmation regarding a particular debtor, the auditor should consider validity of grounds for such a request and assess management's integrity and obtain evidence to support the same. The auditor should also ask the management to submit its request in a written form, dealing therein the reasons for such a request. The auditor agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should document the reasons for acceding to the management's request and should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter. While considering the validity of request, in case the auditor reaches at a conclusion that the same was not valid, he may appropriately modify the report.

Question 15

Answer the following:

(a) Enumerate, in brief, the important aspects to be evaluated by the external auditor in determining the efficiency and extent of reliance to be placed on the work and function of an Internal Auditor. *(6 marks)*

(b) While compiling the financial statements of a concern, you observed that the input information supplied by the concern is incomplete, incorrect and few of the Accounting Standards have not been followed. Describe, in brief, the procedure you will follow in the above. *(5 marks) (Final May 2005)*

Answer

(a) Evaluation of Internal Audit Function: The external auditor should as a part of his audit, carryout general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor. As per SA 610 "Relying Upon the Work of an Internal Auditor", the important aspects to be considered by external auditor are:

(i) *Organisational Status:* An important aspect is whether the audit is being carried out by outside agency or by departmental team. Another related aspect is level in the organisation to whom the report is addressed and whether he is free to communicate with the external auditor.

(ii) *Scope of Function*: Nature and depth of coverage of the internal audit and to what extent the management considers and where appropriate, act upon the recommendations of the internal auditor.

(iii) *Technical competence*: Internal audit work is performed by persons having adequate technical training and proficiency. Professional qualification and experience of the persons carrying out internal audit function also need to be considered.

(iv) *Due Professional care*: It should be ascertained that the internal audit appears to be properly planned, supervised, reviewed and documented. Existence of proper internal audit manual, programmes and working papers will lead to the establishment of due professional care.

The external auditor should document his evaluation and conclusion of all the above factors.

(b) Compilation of Financial Information: According to SRS 4410 "Engagements to Compile Financial Information", an accountant would normally have to rely upon the management for information to compile the financial statements in a compilation engagement. If in the course of compilation of financial statements, it is observed that the information supplied by the entity is incorrect, incomplete or otherwise unsatisfactory, the accountant should perform following procedures:

(i) Make any enquiries of management to assess the reliability and completeness of the information provided;

(ii) Assess internal controls prevailing in the entity; and

(iii) Verify any matters or explanations.

The accountant may also request the management to provide additional information. This may be asked in the form of management representation letter. If the management refuses to provide additional information, the accountant should withdraw from the engagement, informing the entity of the reasons for such withdrawal.

If one or more accounting standards are not complied with, the same should be brought to the notice of the management and if the same is not rectified by the management, the accountant should include the same in notes to the accounts and the compilation report to the management.

Question 16

Answer the following"

(a) *Enumerate (in brief) the basic principles governing an audit.* *(5 Marks)*

(b) *While examining the going concern assumption of an entity, what important indications should be evaluated and examined?* *(6 Marks)* (Final Nov 2005)

Answer

(a) SA 200, "Basic Principles Governing an Audit", describes the basic principles which govern the auditor's professional responsibilities and which should be complied with whenever an audit is carried out. Basic principles are:

(i) **Integrity, Objectivity and Independence:** The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being compatible with integrity and objectivity.

(ii) **Confidentiality:** The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.

(iii) **Skills and Competence:** The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence in auditing.

(iv) **Work performed by others:** When the auditor delegates work to assistants or uses work performed by other auditor and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose.

(v) **Documentation:** The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.

(vi) **Planning:** The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on a knowledge of the client's business.

(vii) **Audit evidence:** The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.

(viii) **Accounting System and Internal Control:** The auditor should reasonably assure himself that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal controls normally contribute to such assurance.

(ix) **Audit conclusions and reporting**: The auditor should review and assess the conclusions drawn from the audit evidence obtain and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.

(b) Evaluating Going Concern Assumption: SA 570, "Going Concern", requires that while planning a performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements. In assessing such a risk, the auditor should examine the following indications.

I. Financial indications

- Negative net worth or negative working capital
- Excessive use of short term borrowing for long term assets
- Fixed term borrowings approaching maturity without prospect of renewal or repayment.
- Adverse key financial ratio
- Substantial operating losses
- Substantial negative cash flow from operations
- Arrears or discontinuance of dividend payment

- Inability to pay creditors in time
- Default in compliance with loan agreements
- Change from credit to cash term with suppliers
- Inability to arrange finance for new development need
- Arrangement with creditors for reduction in liabilities

II. Operating Indications

- Turnover and departure of key management personnel without replacement
- Loss of market, franchise, license or key supplier
- Labour difficulties or shortage of important supplies

III. Other indications

- Non-compliance with statutory requirements
- Legal cases with possibility of adverse judgement which could not be met
- Changes in legislations or government policy
- Sickness of the entity under any statutory definition.

Question 17

Enumerate the risks and internal control characteristics in an audit conducted in Computer Information Systems (CIS) environment. (8 Marks) (Final Nov 2005)

Answer

The risks and internal control characteristics in CIS environment as per SA 315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" and SA 330 "The Auditor's Responses to Assessed Risks" include the following:

- ***Lack of transaction trails***: Some computer information systems are designed so that a complete transaction trail that is useful for audit purposes might exist for only a short period of time or only in computer readable form. Where a complex application system performs a large number of processing steps, there may not be a complete trail. Accordingly, errors embedded in an application's program logic may be difficult to detect on a timely basis by manual (user) procedures.
- ***Uniform processing of transactions****:* Computer processing uniformly processes like transactions with the same processing instructions. Thus, the clerical errors ordinarily associated with manual processing are virtually eliminated. Conversely, programming errors (or other systemic errors in hardware or software) will ordinarily result in all transactions being processed incorrectly.
- ***Lack of segregation of functions****:* Many control procedures that would ordinarily be performed by separate individuals in manual systems may become concentrated in a CIS

environment. Thus, an individual who has access to computer programs, processing or data may be in a position to perform incompatible functions.

- ***Potential for errors and irregularities***: The potential for human error in the development, maintenance and execution of computer information systems may be greater than in manual systems, partially because of the level of detail inherent in these activities. Also, the potential for individuals to gain unauthorised access to data or to alter data without visible evidence may be greater in CIS than in manual systems.

  In addition, decreased human involvement in handling transactions processed by computer information systems can reduce the potential for observing errors and irregularities. Errors or irregularities occurring during the design or modification of application programs or systems software can remain undetected for long periods of time.

- ***Initiation or execution of transactions***: Computer information systems may include the capability to initiate or cause the execution of certain types of transactions, automatically. The authorisation of these transactions or procedures may not be documented in the same way as that in a manual system, and management's authorisation of these transactions may be implicit in its acceptance of the design of the computer information systems and subsequent modification.

- ***Dependence of other controls over computer processing***: *Computer processing may produce reports and other output that are used in performing manual control procedures. The effectiveness of these manual control procedures can be dependent on the effectiveness of controls over the completeness and accuracy of computer processing. In turn, the effectiveness and consistent operation of transaction processing controls in computer applications is often dependent on the effectiveness of general computer information systems controls.*

- ***Potential for increased management supervision***: *Computer information systems can offer management a variety of analytical tools that may be used to review and supervise the operations of the entity. The availability of these analytical tools, if used, may serve to enhance the entire internal control structure.*

- ***Potential for the use of computer-assisted audit techniques***: The case of processing and analysing large quantities of data using computers may require the auditor to apply general or specialised computer audit techniques and tools in the execution of audit tests.

Question 18

A Company gets its accounting data processed by a third party to achieve cost reduction. As a Statutory Auditor of such a company, what are the additional precautions/checks that you would consider for conduct of the audit? (8 Marks)(Final May 2006)

Answer

Precaution to be taken by auditor in case Accounting Data Processed by Third Party: Processing of accounting data may be given to a third party on account of various considerations such as economy, own computer working to full capacity, an interim measures restricting accessibility to sensitive information, etc. A client may use a service organisation such as one that executes transactions and maintains related accountability or records transactions and processes related data (e.g., a computer systems service organisation). If a client uses a service organisation, certain policies, procedures and records maintained by the service organisation might be relevant to the audit of the financial statements of the client. Consequently, the auditor would consider the nature and extent of activities undertaken by service organisations so as to determine whether those activities are relevant to the audit and, if so, to assess their effect on audit risk. SA 402, "Audit Considerations Relating to Entities Using Service Organisations", while planning the audit, the auditor of the client should determine the significance of the activities of the service organisation to the client and their relevance to the audit. In doing so, the auditor of the client would need to consider the following, as appropriate:

- Nature of the services provided by the service organisation.
- Terms of contract and relationship between the client and the service organisation.
- The material financial statement assertions that are affected by the use of the service organisation.
- Inherent risk associated with those assertions.
- Extent to which the client's accounting and internal control systems interact with the systems at the service organisation.
- Client's internal controls that are applied to the transactions processed by the service organisation.
- Service organisation's capability and financial strength, including the possible effect of the failure of the service organisation on the client.
- Information about the service organisation such as that reflected in user and technical manuals, if any.
- Information available on general controls and computer systems controls relevant to the client's applications.

The auditor of the client would also consider the availability of third-party reports from service organisation's auditors, internal auditors, or regulatory agencies as a means of providing information about the accounting and internal control systems of the service organisation and about its operation and effectiveness.

Question 19

Elaborate how the Statutory Auditor can verify the existence of related parties for the purpose of reporting under Accounting Standard 18. *(8 Marks)(Final May 2006)*

Answer

Verification of Existence of Related Parties: Related Parties (for AS 18), the auditor should adopt audit procedures laid down in SA 550, "Related Parties", to identify the existence of such parties. The auditor should review information provided by the management of the entity, identifying the names of all known related parties and should perform the following procedures in respect of the completeness of this information:

(a) review his working papers for the prior years for names of known related parties;

(b) review the entity's procedures for identification of related parties;

(c) inquire as to the affiliation of directors and key management personnel, officers with other entities;

(d) review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a list of principal shareholders from the share register;

(e) review memorandum and articles of association, minutes of the meetings of shareholders and the board of directors and its committees and other relevant statutory records such as the register of directors' interests;

(f) inquire of other auditors of the entity as to their knowledge of additional related parties and review the report of the predecessor auditors;

(g) review the entity's income tax returns and other information supplied to regulatory agencies; and

(h) review the joint venture and other relevant agreements entered into by the entity.

If, in the auditor's judgment, the risk of significant related parties remaining undetected is low, these procedures may be reduced or modified as appropriate.

Question 20

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

You notice a misstatement resulting from fraud or suspected fraud during the audit and conclude that it is not possible to continue the performance of audit.

(5 Marks)(Final Nov 2006)

Answer

Impossibility to continue the performance of audit: If an auditor concludes that it is not possible to continue the performance of auditing because of misstatement resulting from fraud or suspected fraud, he should take action in accordance with the requirement of SA 240 "The Auditor's Responsibility to consider Fraud and Error".

(i) He should consider the professional and legal responsibilities applicable in the circumstances including whether there is a requirement for the auditor to report to the person(s) who made the audit appointment.

(ii) He should consider whether he has to report to the regulatory authorities.

(iii) If the auditor withdraws, he should discuss with the appropriate level of management and those who charged with the governance about the reasons for the withdrawal.

In view of the exceptional nature of circumstances and the need to consider the legal requirement, he may also seek legal advice for determining the appropriate course of action.

Question 21

"The auditors should communicate audit matters of governance interest arising from the audit of financial statements with those charged with the governance of an entity". Briefly state the matters to be included in such Communication. *(8 Marks)(Final Nov 2006)*

Answer

Communications of audit matters with those charged with governance SA 260

SA 260 deals with communications of audit matters with those charged with governance.

The following are the audit matters of governance interest which are to be communicated.

(i) The general approach and overall scope of audit including expected limitations.

(ii) The selection of or change in significant accounting policies and practices that have a material effect on the entity's financial statements.

(iii) The potential effect on the financial statements of any significant risks and exposures.

(iv) Adjustment to financial statements arising out of audit which have a significant effect on the financial statement.

(v) Material uncertainties that may cast significant doubt on the entity's ability to continue as a going concern.

(vi) Disagreement with management on matters which could have significant impact to the financial statements and to audit report.

(vii) Expected modifications to the audit report.

(viii) Others matters like material weakness in internal control measures, questions on management integrity and fraud involving management.

(ix) Other matters agreed in terms of audit engagement.

Question 22

(a) (i) What are general matters to be considered by an auditor while taking up a engagement?

(ii) What are the major sources of obtaining information about the client's business?

(4x2=8 Marks)

(b) State the reporting responsibility of an auditor in the context of non-compliance of Law and Regulation in an audit of Financial Statement. *(8 Marks)(Final Nov 2006)*

Answer

(a) (i) General matters to be considered while taking up a new engagement

General Economic factors: General level of economic activity (for example, recession, growth)

(i) The market and competition.

(ii) Cyclical or seasonal activity

(iii) Government policies

The industry- important conditions affecting the client's business

(i) The market and competitions

(ii) Cyclical or seasonal activity

(iii) Changes in product technology

(iv) Business risk

The entity:

(i) Management and ownership- important characteristics

(ii) Operating Management

(iii) The entity's business – products markets, suppliers, expenses, operations.

(a) Nature of business(es) (for example, manufacturing whole seller, financial services, import/ exports)

(b) Location of production facilities, warehouses, offices.

(c) Employment (for example, by location, supply, wage levels, union contracts, pension commitments, Government regulation)

(d) Products or services and markets.

(iv) Financial performance– factors concerning the entity's financial condition and profitability.

(v) Reporting environment- external influences which affect management in the preparation of the financial statements.

(vi) Legislation:

(a) Regulatory environment and requirements

(b) Taxation both direct and indirect.

(ii) Information about the client's business: The auditor can obtain information about client's business from the following sources:

(i) The client's annual reports to shareholders;

(ii) Minutes of meetings of shareholders, board of directors and important committees;

(iii) Internal financial management report for current and previous periods, including budgets, if any;

(iv) The previous year's audit working papers, and other relevant files;

(v) Firm personnel responsible for non audit services to the client who may be able to provide information on matters that may affect the audit;

(vi) Discussions with the client;

(vii) The client's policy and procedures manual;

(viii) Relevant publications of the Institute of Chartered Accountants of India and other professional bodies, industry publication, trade Journals, magazines, newspapers or text books;

(ix) Consideration of the state of the economy and its effects on the client's business;

(x) Visits to the client's premises and plant facilities to the management.

(b) Reporting responsibility of an auditor in the context of non-compliance of Law and Regulation: The auditor should as soon as practicable, either communicate with the audit committee, the Board of Directors and senior management or obtain evidence that they are appropriately informed regarding non-compliance that comes to the auditors attention.

If in the auditor's Judgment, the non-compliance is believed to be intentional and/ or material, the auditor should communicate the findings without delay.

If the auditor suspects that members of senior management, including members of the Board of Directors, are involved in non-compliance, the auditor should communicate the matter to the next higher level of authority at the entity, such as, the audit committee or Board of Directors, to the users of the auditors report or financial statements.

If the auditors concludes that the non-compliance has a material effect on the financial statements and has not been properly reflected in the financial statements the auditor should express a qualified or an adverse opinion.

If the auditor is precluded by the entity from obtaining sufficient and appropriate audit evidence to evaluate whether non-compliance is, or is likely to have occurred that have or may have material impact on the financial statements, the auditor should express a qualified opinion or a disclaimer of opinion on the financial statements on the basis of a limitation on the scope of the audit.

If the auditor is unable to determine whether non compliance has occurred because of limitations imposed by the circumstances rather then by the entity, the auditor should consider the effect on the auditor's report.

The auditor's duty of confidentiality would ordinarily preclude reporting non compliance to a third party. However, in certain circumstances, that duty of confidentiality is overridden by statement, law or by courts of laws.

Question 23

Write short notes on the following:

(a) Eight situations of external confirmations.

(b) Situations where external confirmations can be used.

(4x 2 = 8 Marks) (Final Nov 2007)

Answer

(a) Eight situations of external confirmations

(i) Bank balances from bankers.

(ii) Accounts receivable balances.

(iii) Accounts payable balances.

(iv) Stocks held by third parties.

(v) Property title deeds held by third parties.

(vi) Investments purchased but delivery not taken.

(vii) Loans from lenders.

(viii) Long outstanding share application money.

(b) Situations where external confirmations can be used: Refer SA 505

(i) Bank balance from bankers

(ii) Account receivable balances

(iii) Stocks held by third parties

(iv) Property title deeds held by third parties

(v) Investments purchased but delivery not taken

(vi) Loan from lenders

(vii) Account payable balances

(viii) Long outstanding share application money.

Question 24

What are the Financial indications to be considered by an auditor for evolution of the going Concern assumption? (4 Marks) (Final Nov 2008)

Answer

As per SA 570 on Going Concern, the following are the financial indications to be considered:-

(i) Negative Net worth;

(ii) Long-term borrowings not being repaid on due dates and without any realistic prospects of renewal or repayment;

(iii) Adverse Financial Ratio;

(iv) Operating losses.

(v) Negative Cash Flow;

(vi) Inability to pay creditors on due dates;

(vii) Increasing credit period from suppliers and entering into a scheme with them for re-schedulement;

(viii) Inability to obtain financing for essential new product development.

NOTE

2
AUDIT PLANNING

Question 1

Write a short note on - Cut-off Procedures. *(4 marks) (Final May 2000)*

Answer

Cut-off Procedures: Cut-off procedures mean procedures employed to ensure the separation of transactions at the end of one year from those in the commencement of the next year. Usually, the problem of overlapping is found in inventory accounting since quite often goods are sold but passed on to the buyer only after the year is over or goods are bought but received only after the close of the year. This situation may create considerable problem for the proper stock taking of inventory. Therefore, the principal areas of application of cut-off procedures involve sales, purchases and stock. The auditor should satisfy himself by examination and test check that these procedures adequately ensure that:

(a) Goods purchased for which property has passed to the client have in fact been included in inventories and that the liability if any, has been provided for.

(b) Goods sold have been excluded from the inventories and credit has been taken for sales.

The auditor may examine a sample of documents evidencing the movement of stocks into and out of stores, including documents pertaining to period shortly before and shortly after the cut-off date, and check whether the stocks represented by those documents were included or excluded, as appropriate, during the stock-taking.

Question 2

You have been appointed the statutory auditor of a private limited company for the first time. Apart from adopting the conventional audit procedures such as posting, casting and vouching, what other auditing techniques would you employ for conducting the statutory audit?

(16 marks) (Final May 2001)

Answer

A statutory auditor conducting audit of a private company for the first time would do well in case he obtains knowledge of the business of the company to understand and assess the kind of audit procedures to be employed by him. Knowledge of the business is a frame of reference within which the auditor exercises professional judgement. Understanding the business and using this information appropriately assists the auditor in:

(i) Assessing risks and identifying problems.

(ii) Planning and performing the audit effectively and efficiently.

(iii) Evaluating audit evidence.

Such knowledge would enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgement, may have a significant effect on the financial statements or on the examination or audit report. As far as adoption of conventional audit procedures is concerned, it would normally involve lot of time without commensurate benefits. In any case, if size of the business is large, the application of conventional procedure would involve extraordinary more time resulting into more cost and even then the auditor would not get the required satisfaction as to the figures contained in the financial statements. There may however, be some instances, say, where internal control systems are quite weak, it may perhaps be advisable to stick to conventional audit procedures such as vouching, etc. in detail. In any case, application of compliance procedure to evaluate the internal control systems in operations would enable the auditor to determine nature, extent and timing of substantive procedures.

Depending upon various factors including size of the business, it is advisable to reduce the extent of checking by adopting test check approach. Test-check approach is an accepted auditing procedure, which aims to test transactions on the basis of selection of samples from the entire population. Audit sampling means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population. It is important to recognise that certain testing procedures do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve sampling. Likewise, applying audit procedures to all items within a population which have a particular characteristic (for example, all items over a certain amount) does not qualify as audit sampling with respect to the portion of the population examined, nor with regard to the population as a whole, since the items were not selected from the total population on a basis that was expected to be representative. Such items might imply some characteristic of the remaining portion of the population. The auditor would also consider the specific audit objectives to be achieved and the audit procedures which are likely to best achieve those objectives. In addition, when audit sampling is appropriate, consideration of the nature of the audit evidence sought and possible error conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes an error and what population to use for sampling. For example, when performing tests of control over an entity's purchasing procedures, the auditor will be concerned with matters such as whether an invoice was clerically checked and properly approved. On the other hand, when performing substantive procedures on invoices processed during the period, the auditor will be concerned with matters such as the proper reflection of the monetary amounts of such invoices in the financial statements.

After performing vouching, it is necessary for an auditor to perform verification of balances contained in the financial statements. Verification and valuation of assets and liabilities contained in the balance sheet would involve obtaining evidence through methods like physical observations, confirmation, computation, inspection of documents and analytical reviews. Direct confirmation procedure provides an independent audit evidence to analyse the financial information contained in the accounting records. For example, confirmation may be done for debtors, creditors, investments lying with third parties, bank balances, etc.

Apart from conducting audit procedures like vouching and verification, it is quite useful to employ analytical review procedures; In fact, analytical review procedures would provide substantive audit evidence to support various assertions in the financial statements. Over a period of time, the analytical review as a method of obtaining evidence has emerged as a significant auditing procedures. As per SA 520, analytical procedures means the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts. Analytical procedures in planning the audit use both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold. The auditor's reliance on substantive procedures to reduce detection risk relating to specific financial statement assertions may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedures to use to achieve a particular audit objective is based on the auditor's judgement about the expected effectiveness and efficiency of the available procedures in reducing detection risk for specific financial statement assertions. It further states that when analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative evidence.

Therefore, a statutory auditor who has been appointed for the first time must resort to evaluation of internal control system through performance of compliance procedures based on the knowledge of the client's business following by vouching on a selected basis having regard to sampling. Physical observation and direct confirmation are also useful audit techniques in the verification of items contained in the financial statements. Ratio analysis or analytical procedures would also provide audit evidence as to various assertions contained in the financial statements.

Question 3

"An auditor while analysing the errors in a sample need not consider the qualitative aspects of errors detected." Please comment. *(8 marks) (Final Nov 2001)*

Answer

Characteristics of Sampling Errors: SA 530, "Audit Sampling", requires that while evaluating sample results, the auditor should analyse any errors detected in the samples having regard to appropriateness of the audit objective. An auditor while evaluating the errors detected in a sample selected by him from the total audit population, should analyse the nature of the errors, the projected errors in the total population and the sampling risk attached to it. While designing an audit sample, the auditor would also need to define the conditions that constitute the error keeping in view the audit objectives.

Flowing from the above, the auditor, therefore, would also need to consider the qualitative aspects of the errors detected by him. This will include the nature and reasons for the error and its possible effect on other phases. In case a repetitive pattern emerges from such analysis, for example, type of transaction, location, product line or period of time, the auditor would need to identify all items in the population, which contain such errors, resulting in a total population. The auditor would then need to carry out a separate analysis based on the examination carried out by him for each such sub-population. Accordingly, the auditor cannot be satisfied by detecting errors only but also would need to consider the qualitative aspects of such errors.

Question 4

Write a short note on - Substantive Procedure. *(4 marks) (Final Nov 2001)*

Answer

Substantive Procedures: SA 200 on "Basic Principles Governing an Audit", lists 'audit evidence' as one of the basic principles governing an audit of financial statements. SA 200 requires that an auditor should perform audit procedures, viz., compliance procedures and substantive procedures to obtain sufficient and appropriate evidence.

As per SA 200, substantive procedures are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. These procedures comprise tests of details of transactions and balances and analysis of significant ratios and trends including the resulting investigation of unusual fluctuations and items.

Obtaining audit evidence from substantive procedures is intended to reasonably assure the auditor in respect of the following assertions:

Existence	-	that an asset or a liability exists at a given date.
Rights and obligations	-	that an asset is a right of the entity and a liability is an obligation of the entity at a given date.
Occurrence	-	that a transaction or event took place which pertains to the entity during the relevant period.

Completeness	-	that there are no unrecorded assets, liabilities or transactions.
Valuation	-	that an asset or liability is recorded at an appropriate carrying value.
Measurement	-	that a transaction is recorded in the proper amount and revenue or expense is allocated to the proper period.
Presentation and disclosure	-	an item is disclosed, classified, and described in accordance with recognised accounting polices and practices and relevant statutory requirements, if any.

The extent and nature of substantive procedures to be performed will vary with respect to each of the above assertions. Obtaining evidence relevant to one of the above assertions will not compensate for failure to do so with respect to another matter concerning the same item, e.g., existence of inventory and its valuation.

Substantive procedures are classified in two categories, viz., tests of detail and analytical procedures. Tests of details involve vouching which primarily deals with transactions and verification normally deals with balances contained in the balance sheet. By performing analytical procedures which aim at calculation of ratios, trends, etc. also aim to provide the auditor with substantive evidence to validate the items contained in financial statements. Such procedures are normally conducted after the auditor has conducted compliance procedures and will be affected by the following factors:

- ♦ Results of the compliance procedures
- ♦ Responses to inquiries as to whether the internal system is functioning
- ♦ Auditors' evaluation of the internal control environment, especially supervisory controls
- ♦ Nature and amount of the transactions or balances involved

Question 5

The auditor "should take into account the aggregate of all uncorrected misstatements including those involving estimates in his assessment of materiality in audit". (8 marks) (Final May 2002)

Answer

SA 320 on "Audit Materiality" requires that in forming his opinion on the financial information, the auditor should consider all material aspects, either individual or in aggregate which are relatively important for true and fair view of financial statements. In this context, the auditor should consider whether the effect of aggregate uncorrected mis-statements on the financial information is material. Qualitative considerations also influence an auditor in reaching a conclusion as to whether the mis-statements are material. As per SA 320, the aggregate of uncorrected mis-statements comprises: (a) specific mis-statements identified by the auditor including the net effect of uncorrected mis-statements identified during the audit of previous periods; and (b) the auditor's best estimate of other mis-statements which cannot be specifically identified (that is, projected errors). The analytical procedures employed by the auditor may give him some indication about the existence of mis-statements, which can be further substantiated by him through estimates process.

When an auditor uses audit sampling to test an account balance or class of transactions, he projects the amount of known mis-statements identified by him in his sample to the items in the balance or class from which his sample was selected. That projected mis-statement, along with the results of other substantive tests, contributes to the auditor's assessment of aggregate mis-statement in the balance or class.

Impact of Misstatements: If the aggregate of the uncorrected mis-statements that the auditor has identified approaches the materiality level, or if auditor determines that the aggregate of uncorrected mis-statements causes the financial information to be materially mis-stated, he should consider requesting the management to adjust the financial information or extending his audit procedures. In any event, the management may want to adjust the financial information for known mis-statements. The adjustment of financial information may involve, for example, application of appropriate accounting principles, other adjustments in amounts, or the addition of appropriate disclosure of inadequately disclosed matters. If the management refuses to adjust the financial information and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected mis-statements is not material, the auditor should express a qualified or adverse opinion, as appropriate.

Question 6

How does an Auditor apply Statistical Sampling in auditing? *(8 marks) (Final Nov 2003)*

Answer

Application of Statistical Sampling in Auditing: Statistical Sampling in auditing stands for the technique of forming an opinion about a group of items on the basis of an examination of a few of the items. On the basis of audit carried out, an auditor is required to give a report containing his opinion about the truth and fairness of the accounting statements. Thus, audit sampling involves the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population. Broadly, the following steps are carried out by the auditor in applying statistical sampling.

In designing an audit sample – the auditor has to consider the specific audit objectives, the population and the sample size.

(i) ***Audit Objectives***: The auditor should consider the specific audit objectives to be achieved to enable him to determine the audit procedure or combinations of procedures which is likely to achieve these objectives. In addition, when audit sampling is appropriate, consideration of the nature of the audit evidence sought and possible error conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes an error and what population to use for sampling. For example, when performing series of control over an entity's purchasing procedures, the auditor will be concerned with matters such as whether an invoice was clerically checked and properly approved. On the other hand, when performing substantive procedures on invoices processed during the period, the auditor will be concerned with matters such as the proper reflection of the monetary amounts of such invoices in the financial statements.

(ii) ***Population***: The population is the entire set of data from which the auditor selects the sample in order to reach a conclusion. The auditor determines that the population from which he draws the sample is appropriate for the specific audit objective. The total number of items potentially subject to scrutiny within a defined area, must be sufficiently large. For example, if the auditor's objective were to test for overstatement of accounts receivable, the population could be defined as the accounts receivable listing.

(iii) ***Confidence Level & Precision****:* In the mathematical probability, the error rate in the sample will not differ from the error rate in the population by more than a stated amount. Confidence level is normally expressed in percentage (90%, 95%, 99%).Precision involves description of the attributes of a given population. But how precise do we require this percentage to be? The bigger our sample, clearly the more precise we can be, but we can never be completely precise for the same reasons as we can never be 100 percent confident. The degree of precision required will depend on the materiality of the items in question. For example, if Rs. 3,000 of errors in a sales ledger population of Rs. 100,000 would be considered to be just not material, then 3 percent would be our precision limits.

Finally, the auditor selects sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected. Selection methods include random selection, systematic selection, haphazard selection, etc. When determining the sample size, the auditor should consider sampling risk, the tolerable error, and the expected error. 'Sampling risk' arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure. Tolerable error is the maximum error in the population that the auditor would be willing to accept and still conclude that the result from the sample has achieved the audit objective. If the auditor expects error to be present in the population, a larger sample than when no error is expected ordinarily needs to be examined to conclude that the actual error in the population is not greater than the planned tolerable error. Smaller sample sizes are justified when the population, the auditor would consider such matters as error levels identified in previous audits, changes in the entity's procedures, and evidence available from other procedures.

The final and last selection in the application of statistical sampling to auditing is the evaluation of sample results by the auditor. The evaluation of sample results involves analyses of any errors detected in the sample, projection of the errors found in the sample to the population, and reassessing the sampling risk.

Question 7

Write a short note on – Enquiry. *(4 marks)(Final Nov 2003)*

Answer

Enquiry: SA 500 "Audit Evidence" mentions inquiry as one of the methods of collecting audit evidence by seeking appropriate information from knowledgeable persons inside or outside the entity. Inquiries may range from formal written inquires addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to enquiries may provide the auditor with information, which he did not previously possess or may not provide him with corroborative evidence. The need for inquiry may arise at every stage of auditing. Wherever any transaction or entry is not readily understandable or its effects are not readily apparent, the auditor should not hesitate to make enquiry from the appropriate official of the client. Apart from this, the auditor of a company has to make a statement in his report on whether he has obtained all the information and explanations that he considered necessary for his audit. This requirement suggests that inquiry is one of the process of the whole scheme of auditing and, accordingly, the Companies Act, 1956 has given certain powers to the auditor in section 227(1) and has cast certain duties on company officials in section 221. Besides, section 227(1A) requires the auditor to make certain specific enquiries during the course of his audit. This requirement is without prejudice to his general rights, powers and duties regarding access to books, etc., and obtaining information and explanations. He is, however, not required to report on the matters specified in this sub-section, unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied.

Question 8

Answer the following:

As an internal auditor for a large manufacturing concern, you are asked to verify whether there are adequate records for identification and value of Plant and Machinery, tools and dies and whether any of these items have become obsolescent and not in use. Draft a suitable audit programme for the above. *(10 marks) (Final May 2005)*

Answer

The Internal Audit Programme in connection with Plant and Machinery and Tools and dies may be on the following lines:

(i) ***Internal Control Aspects**:* The following may be incorporated in the audit programme to check the internal control aspects:

  (a) Maintaining separate register for hired assets, leased asset and jointly owned assets.

  (b) Maintaining register of fixed asset and reconciling to physical inspection of fixed asset and to nominal ledger.

  (c) All movements of assets are accurately recorded.

  (d) Authorisation be obtained for –

    (i) a declaring a fixed asset scrapped.

    (ii) selling a fixed asset.

  (e) Check whether additions to fixed asset register are verified and checked by authorised person.

  (f) Proper recording of all additions and disposal.

  (g) Examining procedure for the purchase of new fixed assets, including written authority, work order, voucher and other relevant evidence.

  (h) Regular review of adequate security arrangements.

  (i) Periodic inspection of assets is done or not.

  (j) Regular review of insurance cover requirements over fixed assets.

(ii) ***Assets Register***: To review the registers and records of plant, machinery, etc. showing clearly the date of purchase of assets, cost price, location, depreciation charged, etc.

(iii) *C**ost Report and Journal Register***: To review the cost relating to each plant and machinery and to verify items which have been capitalised.

(iv) ***Code Register***: To see that each item of plant and machinery has been given a distinct code number to facilitate identification and verify the maintenance of Code Register.

(v) ***Physical Verification***: To see physical verification has been conducted at frequent intervals.

(vi) ***Movement Register***: To verify (a) whether a Movement Register for movable equipments and (b) log books in case of vehicles, etc. are being maintained properly.

(vii) ***Assets Disposal Register***: To review whether assets have been disposed off after proper technical and financial advice and sales/disposal/retirement, etc. of these assets are governed by authorisation, sales memos or other appropriate documents.

(viii) ***Spare Parts Register***: To examine the maintenance of a separate register of tools, spare parts for each plant and machinery.

(ix) ***Review of Maintenance**:* To scrutinise the programme for an actual periodical servicing and overhauling of machines and to examine the extent of utilisation of maintenance department services.

(x) ***Review of Obsolescence**:* To scrutinise whether expert's opinion have been obtained from time to time to ensure purchase of technically most useful efficient and advanced machinery after a thorough study.

(xi) ***Review of R&D***: To review R&D activity and ascertain the extent of its relevance to the operations of the organisation, maintenance of machinery efficiency and prevention of early obsolescence.

Question 9

Comment on the following:

Obtaining audit evidence in performing compliance and substantive procedures.

(10 marks) (Final May 2005)

Answer

Obtaining Audit Evidence: In performing compliance and substantive procedures, the auditor may obtain audit evidence by following methods:

(i) **Inspection:** It consists of examining various records, documents and tangible assets. Examination of these records and assets provides evidence of varying degree of reliability depending upon their nature, source and effectiveness of internal control over their processing. Inspection of tangible assets provides reliable evidence regarding their existence. Four major categories of documentary evidence, which provide different degree of reliability are:

(a) documentary evidence originating from and held by third parties;

(b) documentary evidence originating from third party and held by entity;

(c) documentary evidence originating from the entity and held by third parties;

(d) documentary evidence originating from and held by the entity.

Inspection of tangible assets is one of the methods to obtain reliable evidence with respect to their existence but not necessarily as to their ownership or value.

(ii) **Observation:** It consists of witnessing a process or procedure being performed by others. Observation of physical verification of inventories by the auditor will help in gathering reliable evidence as to their existence, physical condition and control.

(iii) **Inquiry and confirmation:** Inquiry consists of seeking appropriate information from knowledgeable persons inside or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the auditor with information which he did not previously possess or may provide him with corroborative evidence.

Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. For example, the auditor requests confirmation of receivables by direct communication with debtors.

(iv) **Computation:** It consists of checking the arithmetical accuracy of source documents and accounting records and doing calculation to arrive at facts and figures.

(v) **Analytical review:** It consists of studying significant ratios and trends and investigating unusual fluctuations in results.

Question 10

Write short notes on the following:

(a) Walk Through Tests

(b) Factors relevant in evaluation of Inherent Risk *(4 x 2 = 8 marks) (Final May 2005)*

Answer

(a) Walk Through Tests: A walk through is a procedure in which an auditor traces a transaction from its initiation through the company's information systems to the point when it is reflected in the financial reports. The auditor should perform one walk through, at a minimum, for each major class of transactions. A walk-through provides evidence to confirm that the auditor understands (1) the process flow of transactions, (2) the design of identified controls for internal control components, including those related to preventing and detecting fraud, and (3) whether all points in the process have been identified at which misstatements related to relevant financial statement assertion could occur. Walk through also provide evidence to evaluate the effectiveness of the controls' design and confirm that the controls have been placed in operation.

When performing a walk-through, the auditor should:

(i) Be sure that the walk-through encompasses the complete process (initiation, authorization, recording, processing and reporting) for each significant process identified, including controls intended to address fraud risk.

(ii) Ask the entity's personnel, at each of key stage in the process, about their understanding of what the company's prescribed procedures require.

(iii) Determine whether processing procedures are performed as expected on a timely basis, and look for any exceptions to prescribed procedures and controls.

(iv) Evaluate the quality of evidence provided and perform procedures that produce a level of evidence consistent with the auditor's objectives. The auditor should follow the whole process, using the same documents and technology that company staff use, asking questions of different personnel at each significant stage and asking follow- up questions to identify any abuse of controls or fraud indicators.

Once a walk-through is performed, the auditor may carry forward the documentation, noting updates, unless significant changes make preparation of new documentation more efficient. If such significant changes occur in the process flow of transactions or supporting computer applications, the auditor should evaluate the nature of changes and the effect on related accounts. The auditor should determine whether it is necessary to walk through transactions that were processed both before and after the change.

(b) Relevant Factors in evaluation of inherent risk: While developing an overall audit plan, the auditor is required to assess inherent risk at financial statement level and is then required to relate his assessment to material account balances and the class of transactions. To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors, having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment. Normally an auditor evaluates inherent risk by assessing factors such as integrity of the management, experience and knowledge of the management, turnover of key management personnel, circumstances which may motivate the management to misstate the financial statement when its financial performance is not satisfactory, nature of entity's business prone to rapid technological obsolescence, dealing with large number of related parties etc.

Question 11

Designing an Audit Strategy is the backbone of the "Audit Planning" process. Discuss.

(10 marks)(Final May 2006)

Answer

Audit strategy is concerned with designing optimised audit approaches, that seeks to achieve the necessary audit assurance at the lowest cost within the constraints of the information available. The formulation of audit strategy as shall be evident from the process as explained in the following paragraphs in fact shall form the basis of audit planning to achieve the audit objectives in the most efficient and effective manner. Audit strategy generally involves the following steps:

(i) **Obtaining Knowledge of Business**: (Erstwhile AAS 20 &SA 310 " Knowledge of the Business") SA 315 & 330 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" and "The Auditor's Responses to Assessed Risks" states that in performing an audit of financial statements, the auditor should have or obtain knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgement, may have a significant effect on the financial statements or on the examination or audit report. Knowledge of the business is a frame of reference within which the auditor exercises professional judgement. Understanding the business and using this information appropriately assists the auditor in assessing risks and identifying problems, planning and performing the audit effectively and efficiently. It also ensures that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to enable them to carry out the audit work delegated to them. This would also ensure that the audit staff understands the need to be alert for additional information and the need to share that information with the auditor and the other audit staff.

(ii) **Performing Analytical Procedures**: The purpose of analytical procedures at the planning stage is attention-directing; corroboration is not normally necessary at this stage. The use of the analytical procedures during the planning stage requires the extensive use of accounting and business knowledge and experience to assess the potential for material misstatement in the financial statements as a whole, because the key aspect of the task is to identify the relevant risk indicators and to interpret them properly. Furthermore, analytical techniques applied during the planning stage are not generally as precise as the analytical techniques at the substantive stage.

(iii) **Evaluating Inherent Risk**: To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors such as quality of accounting system, unusual pressure on management, etc. having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which, might have taken place since his last assessment.

(iv) **Evaluating Internal Control**: The auditor's assessment of the control environment is crucial to the decision on whether to make an extended assessment of controls. This is because a good control environment is conducive to the maintenance of a reliable system of accounting and control procedures. For strategy purposes, the auditor should obtain a sufficient understanding of the control environment. The auditor needs an understanding of the accounting systems, regardless of whether the audit strategy will involve an extended assessment of internal accounting controls. This is done by:

(a) considering the results of gathering or updating information about the client; and

(b) making preliminary judgements about materiality, inherent risk and control effectiveness. These will include identification of the system(s) the auditor proposes to subject to an extended assessment of controls.

Thus, the audit strategy is evolved after considering the engagement objectives, the results of the business review, preliminary judgements as to materiality and identified inherent risks. Audit strategy also considers main points relating to planning and controlling the audit or comments on adequacy of the existing arrangements. Thus, the overall audit plan involving determination of timing, manpower, coordination and the directions in which the audit work has to proceed is dependent upon the audit strategy formulated by the audit firm.

Question 12

As an internal auditor of a Cement Manufacturing Company, draft an audit programme for verification of transportation charges for despatches from the factory.

(8 marks)(Final May 2006)

Answer

Procedure for Audit of Transportation Charges

(i) Check rates contracted with transporters for carriage of goods.

(ii) Check whether the rates mentioned as per the contract are correctly taken in the transporter's Invoice.

(iii) In case of discrepancy, check whether the same is authorized by the appropriate sanctioning authority.

(iv) Check that the transporter's invoice includes a delivery challan which has customers stamp indicating the receipt of the goods.

(v) In case there is no stamp on the delivery challan, check whether the goods are received back and there is a corresponding inward note.

(vi) Check whether all the goods to be dispatched have a transport booking order reference.

(vii) Check whether each transporter's invoice mentions the transport booking order reference.

(viii) Check whether all the transport booking orders have corresponding transporters names.

(ix) Check whether the transport booking orders are prenumbered.

(x) Check whether all the invoices are correctly booked in the books of accounts.

(xi) In case there is an additional charge by the transporter due to extra carriage, check for the relevant supporting **records** (like material Inward Note/Customer Rejection Note) and necessary authorization by the sanctioning authority.

(xii) Check whether service-tax on the transporters is correctly calculated and accounted.

(xiii) Verify that for there is a mechanism for linking all the Transport Bills to the sale invoices.

Question 13

Write a short note on - Analytical procedures in planning an audit.

(4 marks) (Final May 2007)

Answer

Analytical procedures in planning an audit: In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures.

Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, the square feet of selling space, volume of goods produced and similar information.

Question 14

As a chartered accountants firm draft an engagement letter to the Board of Directors for the compilation of financial statements of XYZ Ltd. as at 31.3.2007. (16 Marks) (Final May 2007)

Answer

Engagement letter to the Board of Directors for the compilation of financial statements of XYZ Ltd. as at 31.3.2007

To

The Board of Directors

XYZ Ltd.

…………

You have vide your letter dated ………requested that we compile the Balance Sheet of XYZ. Ltd. as at 31.3.2007 and the related Profit and Loss account for the year ended on that date.

We are pleased to confirm our acceptance and understanding of the engagement by means of this letter. As no audit or review engagement procedures would be carried out, no opinion on the financial statements will be expressed. Further, our engagement cannot be relied upon to disclose whether frauds or defalcations, or illegal acts exist. However, we will inform you of any such matters which might come to our attention in the course of the engagement.

As Management, you are responsible for :

(a) The accuracy and completeness of the information supplied to us, including maintenance of adequate accounting records and internal controls and selection and application of appropriate accounting policies.

(b) Preparation and presentation of the financial statements of the entity, in accordance with the applicable laws and regulations, if any.

(c) Safeguarding the assets of the entity and also establishing appropriate controls designed to prevent and detect fraud and other irregularities.

(d) Ensuring that the activities of the entity are carried on in accordance with applicable laws and regulations and that it institutes appropriate controls to prevent and detect any non-compliance.

You will confirm that events and transactions are recorded in accordance with the applicable accounting standard(s), issued by the Institute of Chartered Accountants of India and other recognized accounting principles and practices and inform us of any departures therefrom.

As part of our normal procedures, we may request you to provide written confirmations of any information or explanations given to us orally during the course of our work.

We understand that the intended use and distribution of the information we have compiled is ………(specify purpose)

We look forward to full co-operation with your staff and we trust that they will make available to us whatever records, documents and other information requested in connection with our engagement.

Our fees will be billed as the work progresses.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our compilation of your financial statements.

XYZ & Co.
Chartered Accountants
S/d

Question 15

M/s PQR & Company, Chartered Accountants have been appointed Statutory Auditors of a listed Company for the year ended 31st March, 2008. Draft an appropriate engagement letter to be sent to the Board of Directors for the same. *(12 marks)(Final Nov 2007)*

Answer

Draft of an Engagement Letter

To the Board of Directors

You have requested that we audit the balance sheet of (Name of the Company) as at 31st March, 2008 and the related profit and loss account and the cash flow statement for the year ended on that date. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the firm statements.

We will conduct our audit in accordance with the auditing standards generally accepted in India and with the requirements of the Companies Act, 1956. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

However, having regard to the test nature of an audit, persuasive rather than conclusive nature of audit evidence together with inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements of financial statements, resulting from fraud, and to a lesser extent error, if either exists, may remain undetected.

In addition to our report on the financial statements, we expect to provide you with a separate letter concerning any material weaknesses in accounting and internal control systems which might come to our notice.

The responsibility for the preparation of financial statements on a going concern basis is that of the management. The management is also responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards. The management is also responsible for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.

The responsibility of the management also includes the maintenance of adequate accounting records and internal controls for safeguarding of the assets of the company and for the preventing and detecting fraud or other irregularities. As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' under the Chartered Accountants Act, 1949. The reviewer may examine our working papers during the course of the peer review.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records; documentation and other information are requested in connection with our audit.

Our fees will be billed as the work progresses.

This letter will be effective for future years unless it is terminated, amended or superseded.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

PQR & Co.
Chartered Accountants
…………………………

(Signature)
(Name of the Member)
(Designation)

Date :

Place :

Acknowledged on behalf of
__________Company by
……………………..

(Signature)
Name and Designation
Date

Question 16

What is an Audit Trail? *(4 marks) (Final May 2008)*

Answer

Audit Trail: Audit Trail can be defined as those documents, records, journals, ledgers, master files etc. that enables an auditor to trace the transactions from the source document to the summarised total in accounting reports or vice-versa.

Audit trail is the visible means whereby the auditor may have a business transactions through all the stages in which it features in the records of the business. For example, sequentially numbered sales invoice copies would normally be listed in a register or day book and subsequently filed either in numerical or chronological sequence. It would then be possible to trace a particular invoice from the day book to the original file or vice-versa by reference to the number or date of the invoice.

In a manual accounting system, it is possible to relate the recoding of a transaction at each successive stage enabling an auditor to locate and identity all documents from beginning to end for the purposes of examining documents, totalling and cross-totalling referencing.

However, in an EDP environment, the use of exception reporting by management has effectively eliminated the audit trail between input and output. Frequently computer generated totals, analysis and balances are not printed out in detail because the management is not exercising control through verification of the individual items processed.

Question 17

What is Haphazard Sampling? *(6 marks) (Final May 2008)*

Answer

Haphazard Sampling: In haphazard selection, the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

Haphazard selection of sample, may be an acceptable alternative to random selection of sample, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units.

When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily located, as they may not be representative.

Question 18

Explain the concept of Audit risk:

(i) At the level of financial statements

(ii) At the level of account balance and class of transactions.

(4 marks x 2= 8)(Final May 2008)

Answer

(i) Audit risk at the financial statement level*:* Audit risk is considered at the financial statement level during the audit planning process. At this time, the auditor should undertake an overall audit risk assessment based on his knowledge of the client's business, industry, management, control environment and operations. Such an assessment provides preliminary information about the general approach to the engagement, the auditor's staffing needs and the framework within which materiality and audit risk assessment can be made at the individual account balances or class of transactions level. For assessing inherent risk, the auditor uses professional judgement to evaluate numerous factors, examples of which are:

- The integrity of management
- Management experience, knowledge and changes during the period (e.g. the inexperience of management may affect the preparation of the financial statements of the entity)
- Unusual pressure on management
- The nature of entity's business (e.g. its technological obsolescence of products and services, complex capital structure, significance of related parties and the number of locations and geographical spread of its production (facilities), factors affecting the industry in which the entity operates (e.g. economic and competitive conditions, changes in technology).

(ii) Audit risk at the account balance and class of transactions level: Majority of audit procedures are directed to, and carried out at the account balance and class of transactions level. Accordingly, audit risk should be considered by the auditor at this level taking into account the results of the overall audit risk assessment made at the financial statement level. To assess inherent risk, the auditor uses professional judgement to evaluate numerous factors, examples of which are:

(i) The complexity of underlying transactions which might require the use of the work of an expert;

(ii) Susceptibility of assets to loss or misappropriation;

(iii) The completion of unusual and complex transactions, particularly at or next year end, and

(iv) Transactions not subjected to the normal processing mode.

Question 19

Write a short note on - Stages in Risk Based Internal Audit. *(4 marks) (Final Nov 2008)*

Answer

Risk Based Internal Audit - Comprises of 3 stages:

- Assessing Risk Maturity
- Preparing Periodic Audit Plan.
- Conducting individual assurance audit assignments and reporting to appropriate levels.

3

INTERNAL CONTROL

Question 1

Internal Audit said to be an "Independent appraisal activity within an organisation for review of accounting, financial and other operations as a basis of service to the organisation, it is a managerial control which functions by measuring and evaluating the effectiveness of other controls". Explain briefly. *(8 marks) (Final May 2000)*

Answer

Traditionally, the expression, 'internal audit' refers to an audit conducted on behalf of the management to ensure that the existing internal controls are adequate and effective; the financial accounting and other records and reports show results of actual operations accurately and promptly; and each unit of the organization follows the policies and procedures as laid down by the top management. Thus, during initial stages, the internal auditor's significant emphasis was on detection of errors and frauds focused on financial aspects of the enterprise.

Over a period of time, the participation in non-financial areas increased rapidly since the business scene was changing very fast. Pressure on the managements was building up due to enormous growth of organisations in size and operations. The complexity of business activities and voluminous transactions led to increasing dependence on large number of people. It was in this context that the management recognised the possibility of utilising the services of internal audit department in a much more effective manner. And this was possible with only a little extra expenditure. It was strongly felt that the expertise built by the internal auditor in financial operations should be equally useful for non-financial operation of the enterprise as well. This is how in the expression given in the question all three words viz. "accounting", "financial" and "other operations" stand on equal importance. The Statement of Responsibilities of Internal Auditor issued in 1971 by the Institute of Internal Auditors, USA cut the umbilical cord to the books of account and simply defined internal auditing as, Internal auditing is, "the review of operations as a service to management". With this revision of definition, it was made clear that accounting activity is also one of the operational areas of the entity like production, research and development, personnel, marketing, etc. In 1981, the definition was modified as under:

"Internal auditing is an independent appraisal function established within the organization to examine and evaluate its activities as a service to the organisation. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls."

With this, internal auditing came to be recognised as a management resource- an important part of the total internal control system for which management is primary responsible. Today, the total range of services rendered by the internal auditor covers both protective needs and constructive needs stressing on performance and operations. Specifically, the range of activities as outlined in the Statement of Responsibilities of Internal Auditors is as follows:

(i) Reviewing and appraising the soundness, adequacy and application of accounting, financial, and other operating controls, and promoting effective control at reasonable cost.

(ii) Ascertaining the extent of compliance with established policies, plans and procedures.

(iii) Ascertaining the extent to which company's assets are accounted for and safeguarded from losses of all kinds.

(iv) Ascertaining the reliability of management data developed within the organisation.

(v) Appraising the quality of performance in carrying out assigned responsibilities.

(vi) Recommending operating improvements.

A close examination of those services help us in identification of primary protective services viz second, third and fourth, and those that are primarily directed to further improvement in operations (i.e. the first, fifth, and sixth).

The modern concept of internal auditing suggests that internal auditing need not be confined to financial transactions and that its scope may be extended to the task of reviewing whether the resource utilisation of the enterprise is efficient and economically. This would necessitate a review of all operations of the enterprise as also an evaluation of the effectiveness of management. In this sense, the internal auditor performs what is known as 'Operational audit' or 'Management audit'. Thus, the expression makes it clear that the scope of activities of internal auditor is not restricted to financial areas but extends to non-financial areas as well.

(Note: Recently, the Institute of Internal Auditors itself has revised the definition of Internal Auditing. The revised definition is:

"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process).

Question 2

Briefly discuss the compliance procedures and their use in evaluation of internal controls.

(8 marks) (Final Nov 2001)

Answer

Compliance Procedures and Evaluation of Internal Controls: SA 200 on “Basic Principles Governing an Audit” states that, “the auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information. According to it, compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. Obtaining audit evidence from compliance procedures is intended to reasonably assure the auditor in respect of the following assertions :

Existence	-	that the internal control exists.
Effectiveness	-	that the internal control is operating effectively.
Continuity	-	that the internal control has so operated throughout the period of intended reliance.

The auditor formulating his opinion on financial information needs reasonable assurance that transactions are properly authorised and recorded in the accounting records and that the transactions have not been omitted. Internal controls, even if fairly simple, may contribute to the reasonable assurance the auditor seeks. The auditors' objective in studying and evaluating internal controls is to establish the reliance he can place thereon in determining the nature, timing and extent of his substantive auditing procedures.

Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in place and are also effective. Compliance procedures enable the auditor to determine the existence, effectiveness and continuous operation of the internal control system. These procedures include tests requiring inspection of documents supporting transactions to gain evidence that controls have operated properly. For example, the auditor may see that the documents have been properly authorised. The auditor may also make enquiries about the observation of controls, for example, determining who actually performs each function not merely who is supposed to perform it. Compliance procedures are conducted by the auditor to gain evidence that those internal controls on which he intends to rely operates generally as identified by him and they function effectively throughout the period of intended reliance. The concept of effective operation recognises that some deviations from prescribed controls may have occurred.

Based on the results of his compliance procedures, the auditor evaluates whether the internal controls are adequate for his purpose. If based on the results of the compliance procedures, the auditor concludes that it is not appropriate to rely on a particular internal control to the degree previously contemplated, he should ascertain whether there is another control which would satisfy his purpose and on which he might rely (after applying appropriate compliance procedures). Alternatively, he may modify the nature, timing or the extent of his substantive audit procedures.

Question 3

Write a short note on - Audit Risk. *(4 marks) (Final May 2002)*

Answer

Audit Risks: Audit risk is the risk that an auditor may give an inappropriate opinion on financial information that is materially misstated. For example, an auditor may give an unqualified opinion on financial statements without knowing that they are materially misstated. Such risk may exist at overall level or while verifying various transactions and balance-sheet items. Low risk areas are those which require the application of routine “nuts and bolts” audit procedures in the ordinary course of vouching, casting, checking, etc., at both compliance and substantive stages, usually occupying up to 80% of all audit effort. High-risk areas are those, which should be the primary concern of partners and senior managers, and will include such matters as: adequacy of provisions; full disclosure of liabilities including contingent liabilities; interpretation of SAs and company legislation; etc. Three components of audit risk are:

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

The nature of each of these types of risk and their interrelationship is discussed below:

Inherent risk is the susceptibility of an account balance or class of transactions to misstatement in other balances or classes, assuming that there were no related internal controls. It is a function of the entity’s business and its environment and the nature of the account balance or class of transactions. For example, accounts involving a high degree of management judgement, or that are difficult to compute, such as a complex accounting estimate, or that involve highly desirable and movable assets, such as jewellery, or that are particularly susceptible to changes in consumer demand or technology that could affect their value, will involve more inherent risk than other accounts.

Control risk is the risk that misstatement that could occur in an account balance or class of transactions and that could be material, individually or when aggregated with mis-statements in other balances or classes, will not be prevented or detected on a timely basis by the system of internal control. There will always be some control risk because of the intrinsic limitation of any control design, as well as test adherence to control procedures. In the absence of such an assessment, the auditor should assume that control risk is high.

Detection risk is the risk that an auditor’s procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, 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 balance or class of transaction because, for example, the auditor may select an inappropriate audit procedure, misapply an appropriate audit procedure or misinterpret the audit results.

Inherent and control risks differ from detection risk in that they exist independently of an audit of financial information. Inherent and control risks are functions of the entity’s business and its environment and the nature of the account balances or classes of transactions, regardless of whether an audit is conducted. Even though inherent and control risks 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 audit risk to an acceptably low level.

Question 4

"Surprise Checks" help the auditors to ascertain whether the internal control system is operating effectively in a Company or not. Discuss. (8 marks) (Final May 2003)

Answer

Surprise Checks: The erstwhile AAS 6 & Standard on Auditing 400, "Risk Assessment and Internal Control", (hitherto known as SA 315 & SA 330)* prescribes that "the auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level." The understanding of the accounting and internal control system can be obtained in several ways including inspection of documents making inquires of appropriate management, observation of activities, etc. It is in this context, surprise checks intend to ascertain whether the system of internal control is operating effectively and whether the accounting and other records are prepared concurrently and kept up-to-date. Particularly, the observation of the entity's activities and operations including observation of the organisation of computer operations, personnel performing control procedures and the nature of transaction processing on a surprise visit would reveal the exact manner in which the activities are being performed in the manner prescribed by the management. It has often been found that manipulations and frauds are facilitated under a system of book-keeping, which does not give proper emphasis to the need to keep the books up-to-date. Errors in book-keeping are often indicative of weaknesses in internal control which may be taken advantage of in order to perpetrate frauds or manipulations. Surprise checks are a useful method of determining whether or not such errors exist and where they exist, of bringing the matter promptly to the attention of the management so that corrective action is taken immediately. Consequently, surprise visits by the auditor can exercise a good moral check on the client's staff.

The Guidance Note issued by the Institute on the subject specifies that surprise checks are a part of the normal audit and the results of such checks are therefore important primarily to the auditor himself in deciding the scope of his audit and submitting his report thereon. The need for and frequency of surprise checks is obviously a matter to be decided having regard to the circumstances of each audit. It would depend upon the extent to which the auditor considers the internal control system as adequate, the nature of the clients' transaction, the locations from which he operates and the relative importance of items like cash, investments, stores etc. However, wherever feasible a surprise check should be made at least once in the course of an audit. If this surprise check reveals any weaknesses in the system of internal control or any fraud or error or the fact that any book or register has not been properly maintained or kept up-to-date, the auditor should communicate the same to the management and ensure that action is taken on the matters communicated by him. It does not necessarily follow that all or any of the matters communicated to the management should form part of the auditor's report on the accounts. Thus "surprise checks" help the auditors, during the course of their audit, to ascertain whether the internal control is operating effectively in a company or not.

*(NOTE: SA 315 issued in December, 2007. The date this Standard (along with SA 330) becomes effective, the existing Standard on Auditing (SA) 400, "Risk Assessments and Internal Control", SA 310, "Knowledge of the Business", and SA 401, "Auditing in a Computer Information Systems Environment", issued in June 2002, April 2000 and January 2003, respectively, would stand withdrawn).

Question 5

(a) Underwriting function and its internal control procedures. *(4 marks)*

(b) Can a statutory auditor act as a book-keeper and as an internal auditor? *(4 marks)*

(Final May 2003)

Answer

(a) Underwriting function and its internal control procedures: The underwriting function, which comprises of examination and evaluation of applications for insurance, the rating of risks and the establishment of premiums, is fundamental to the operations of a general insurance company. The prime objectives of an internal control system for underwriting is adherence to guidelines for acceptances of insurance, proper recording of insurance risk and its evaluation. The following, therefore, may be the internal control procedures with regard to the underwriting:

(i) Appropriate and clear underwriting guidelines are framed and communicated to the underwriting department and the intermediaries where such guidelines are executed with a reasonable certainty without providing substantial flexibility to the underwriters. The adherence to these guidelines should be monitored by an appropriate official of the company.

(ii) Firm procedures are instituted to ensure adequate investigation of the risks assumed (e.g., medical or other investigative reports are duly obtained from the insured).

(iii) There is an effective communication between claims and underwriting department.

(iv) The relevant information is processed on a timely basis to avoid processing backlogs.

(v) Suspense/ unreconciled account balances are reviewed and analysed on a timely basis by responsible officials.

(vi) Guidelines for reinsurance are established and monitored by a responsible officer.

(vii) Adequate systems are developed to identify existence of premium deficiency, if any, and the calculation in respect thereof is regularly performed and approved by an appropriate official.

(b) Can a statutory auditor act as a book-keeper and as an internal auditor: Professional integrity and independence is an essential characteristic of all the learned professions but is more so in the case of accounting profession. 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. In all phases of a Chartered Accountant's work, he is expected to be independent, but in particular in his work as auditor, independence has a special meaning and significance. Not only the client but in the case of companies, also the shareholders, prospective investors, bankers and government agencies rely upon the accounts of an enterprise when they are audited by a Chartered Accountant. As statutory auditor of the accounts of a limited company, for example, the Chartered Accountant would cease to perform any useful function if the persons who rely upon the accounts, of the company do not have any faith in the independence and integrity of the Chartered Accountant. In such cases he is expected to be objective in his approach, fearless, and capable of expressing an honest opinion based upon the performance of work such as his training and experience enables him to do.

In view of the above, a statutory auditor either performing as a book-keeper or an internal auditor would not be in a position to act in an independent manner on the subject matter prepared by him. If a person who writes the books of account would not be in a position to express an opinion on the appropriateness or otherwise of the same. Accordingly, the Council has clarified that the members are not permitted to write the books of account of their auditee clients. As back as in 1963, Seventh Annual Report on Working and Administration of Companies Act, 1956 clarified the acceptance of the book-keeping work by the statutory auditor is likely to place the statutory auditor in a rather vulnerable position in the matter of free expression of his professional opinion as an auditor on the annual accounts of the company.

Regarding the internal auditor, the Code of Ethics also recommend that a statutory auditor of a company cannot also be its internal auditor, as it will not be possible for him to give independent and objective report issued under sub-section 4A of section 227 of the Companies Act, read with the Companies (Auditor's Report) Order, 2003. Further as per circular issued by the Department of Company Affairs in case the statutory auditor of the company is also the internal auditor, it will not be possible for him to give an independent and objective report under section 227. As such a statutory auditor of a company cannot also be its internal auditor.

Question 6

Write a short explanatory note on - Flow chart technique for evaluation of internal control.

(4 marks) (Final May 2004)

Answer

Flow-chart technique for evaluation of internal control: A flow-chart is a graphic presentation of the flow of transactions and documents in an organisation. Evaluation of the internal controls forms an important part of the auditing process as it enables the auditor to know the weaknesses and strengths of the accounting system and consequently the general reliability of the accounting records and data emanating therefrom. Also, it helps the auditor to decide upon the relative audit thrust needed in the different accounting areas. A properly drawn up flow chart can provide a neat visual picture of the whole activities of the section or department involving flow of documents and activities. More specifically it can show:

(i) at what point a document is raised internally or received from external sources;

(ii) the number of copies in which a document is raised or received;

(iii) the intermediate stages set sequentially through which the document and the activity pass;

(iv) distribution of the documents to various sections, departments or operations;

(v) checking authorisation and matching at relevant stages;

(vi) filing of the documents; and

(vii) final disposal status.

Different methods are available with the auditor to evaluate the internal controls but the flow-charting method is, perhaps, the most scientific and advantageous as compared to other methods. It provides the most concise but comprehensive way of recording the operating controls along with the flow of transactions and documents. In the flow-chart, a total and complete visual picture and control system is available and as such its reception in the human mind is direct. In drawing a flow-chart, organised and concentrated application of mind is essential to reflect the control system in a rational manner. Even in a large and complex organisation, the control system could be depicted by few sheets of neatly drawn flow-charts. However, in drawing the flow chart, the auditor has to take few precautions, e.g., flow-charts should not be lengthy and cumbersome, should be neat, should portray the flow completely with final **disposal** of papers and there should be proper use of symbols and lines. The auditor will be able to visually correlate the functions and the related controls and assess the adequacy and effectiveness thereof much quickly than a possibly in any other method.

Question 7

As the Statutory Auditor of a Manufacturing Company, what are the points you will consider to conclude "Whether the company has an Internal Audit system commensurate with the size of the company and its operations"? *(8 marks)(Final Nov 2007)*

Answer

This clause has mandatory application in case of companies having a paid-up capital and reserves exceeding rupees 50 lacs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crores rupees for a period of three consecutive financial years immediately preceding the financial year concerned. 'Financial year concerned' means the financial year under audit. This clause also mandatory applicable for the listed companies irrespective of the size of paid-up capital and reserves or turnover.

The auditor has to examine whether the internal audit system is commensurate with the size of the company and the nature of its business. The following are some of the factors to be considered in this regard:

(i) What is the size of the internal audit department? In considering the adequacy of internal audit staff, it is necessary to consider the nature of the business, the number of operating points, the extent to which control is decentralised, the effectiveness of other forms of internal control, etc.

(ii) What are the qualifications of the persons who undertake the internal audit work? Internal auditing is reasonable to expect that the internal audit department should normally be headed by a chartered accountant and that, depending upon the size of the department, it employs other qualified persons.

(iii) To whom does the internal auditor report? In general, the higher the level to which the internal auditor reports, the greater will be his independence.

(iv) What are the areas covered by the internal audit? Internal audit can cover a large number of areas including operational auditing, organisation and methods studies, special investigations and the like.

(v) Has the internal auditor adequate technical assistance? This can be provided either by having full-time technically qualified persons in the internal audit department or by such persons being deputed to the internal audit department for specific assignments.

(vi) What are the reports which are submitted by the internal auditor or what other evidence is there of his work? Auditor should satisfy himself that an internal audit system is functioning effectively. He can do so by examining the reports submitted by the internal auditor.

(vii) What is the follow-up? It is necessary that there is an adequate follow-up system to ensure that the errors pointed out are corrected and remedial action taken on the deficiencies reported upon.

NOTE

4
COMPANY AUDIT

Question 1

State your views as an auditor on the following:

(a) T Ltd. purchased goods on credit for Rs.5 crores for export from ABC Ltd. Upon the export order being cancelled, T Ltd. decided to sell the same in the domestic market at a discounted price. Accordingly ABC Ltd was requested to offer a price discount of 25%. ABC Ltd. wants to adjust the sales figure to the extent of discount requested by T Ltd.

(5 marks)

(b) During the year under audit Z Ltd. credited to the Profit and Loss Account, the entire profit of Rs.20 lakhs on the sale of land not required for its use. You are informed that the directors would like to propose dividend out of the above profit. (5 marks)

(c) Y Ltd. provided Rs.25 lakhs for inventory obsolescence in 1998-1999. In the subsequent years, it was determined that 50% of such stock was usable. The company wants to adjust the same through prior period adjustment account as the provision was made in the earlier year. (5 marks)

(d) V V Ltd. had announced a voluntary retirement plan for its employees on January 1, 2000. The scheme is scheduled to close on June 30, 2000. The scheme envisaged an initial lump sum payment of maximum of Rs. 2 lakhs and monthly payments over the balance period of service of employees coming under the plan. 200 employees opted for the scheme as on March 31, 2000. The total lump sum payment for these employees would be Rs. 250 lakhs and the aggregate of future payments to them would amount to Rs.1,500 lakhs. However, no payment had been made to the employees under the scheme up to March 31, 2000. Nor the company made any provision in its accounts towards any liability under the scheme. (5 marks) (Final May 2000)

Answer

(a) ABC Ltd. had sold goods on credit worth Rs.5 crores to T Ltd. and, therefore, the sale was complete in all respects. T Ltd' s decision to sell the same in the domestic market at a discount does not affect the amount booked under sales by ABC Ltd. The price discount of 25% offered by ABC Ltd. at the request of T Ltd. was not in the nature of discount given during the ordinary course of trade because otherwise same would have been given at the time of sale itself. Now as far as ABC Ltd. is concerned, there appears to be an uncertainty relating to collectability, which has arisen subsequent to the time of sale. Therefore, it would be appropriate to make a separate provision to reflect the uncertainty relating to collectability rather than to adjust the amount of revenue originally recorded. Therefore such discount should be written off to the profit and loss account and not shown as deduction from the sales figure.

(b) Profit of Rs. 20 lakhs on the sale of land is a capital profit. It represents the excess of sale value over the original cost of the asset. The question whether such a profit can be distributed as dividend has been considered in two legal cases, viz., *Lubbock* vs *The British Bank of South America Ltd. and Foster* vs *The New Trinidad Lake Asphalte Co. Ltd.* Based on the Court judgements, it is argued that capital profits can be distributed by a company only if all the following conditions are fulfilled:

(i) The articles of association should permit distribution of capital profits.

(ii) The capital profit which is sought to be distributed should have actually been realised.

Unrealised capital profits, e.g., those arising on a revaluation of fixed assets, cannot be distributed as dividends. However, if the assets so revalued are subsequently sold, the amount realised over and above the original cost of such assets is a capital profit available for distribution as dividend (provided the other conditions are satisfied).

(iii) The capital profit should remain after a proper valuation has been fairly taken of the whole of the assets and liabilities. In other words, any fall or deficiency in the value of other assets or appreciation in the amount of liabilities should be deducted from the amount of capital profits to ascertain the amount which can properly be regarded as distributable as dividend.

However, Accounting Standard 10 on "Accounting for Fixed Assets" requires that any gain arising from disposal of a fixed asset should be recognised in the profit and loss account. Moreover, section 205 of the Companies Act, 1956 does not make any distinction between capital profit and other profit. Thus, all profits which can properly be taken to the profit and loss account are 'profits' for the purposes of section 205 and are, thus, distributable.

(c) As per AS 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The write-back of provision made in respect of inventories in the earlier year does not constitute prior period adjustment since it neither constitutes error nor omission but it merely involves making estimates based on prevailing circumstances when financial statements were being prepared. It is a mere estimate process involving judgement based on the latest information available. An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item. In this case, T Ltd. provided Rs.25 lakhs for inventory obsolescence in 1998-99. In the subsequent year due to change in circumstances, it was determined that 50% of such stock was usable. Revision of such an estimate does not bring the resulting amount of RS.12.5 lakhs within the definition either of a prior period item or of an extraordinary item. The amount, however, involved is material and requires separate disclosure to understand the financial position and performance of an enterprise. Accordingly, the accounting treatment followed by the company is not proper.

(d) Accounting Standard (AS) 4 (Revised) on 'Contingencies and Events Occurring After the Balance Sheet Date', states that events occurring after the 'balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company and by the corresponding approving authority in the case of any other entity.

Two types of events can be identified as:

(a) those which provide further evidence of conditions that existed at the balance sheet date; and

(b) those which are indicative (of conditions that arose subsequent to the balance sheet date).

It further states that assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.

As per facts of the case, a condition existed on the balance sheet date (31st March, 2000) regarding the liability towards the Voluntary Retirement Plan (VRP) since the management started the VRP in the month of January, 2000 and 200 employees opted for the VRP as on March 31, 2000. Since it was probable that future events will confirm that a liability has been incurred on the balance sheet date and that the amount could be estimated on reasonable basis, a provision for payments under the VRP would be required to be made for an appropriate amount for the aforesaid number of employees.

Question 2

You have been appointed a statutory auditor of a limited company engaged in the manufacture of chemicals. What would be your views on the following?

(a) The management tells you that the work in process is not valued since it is difficult to ascertain the same in view of the multiple processes involved and in any case the value of opening and closing work in process would be more or less the same. (5 marks)

(b) The company has a turnover exceeding Rs.5 crores for a period of three consecutive financial years immediately preceding the financial year concerned, but does not have any internal audit system. (5 marks)

(c) *The management tells you that there is no need for them to follow accounting standards specified by the Institute of Chartered Accountants of India as these are for the auditor to follow.* *(5 marks)*

(d) *The company has suffered a net loss for the year. The directors however declared and paid an interim dividend @ 30% based on the half-yearly performance.*
(5 marks) (Final May 2001)

Answer

(a) Valuation of Work-in-Process: As per AS 2 (Revised) on "Valuation of Inventories", the inventories also include those assets which are in the process of production for sale in the ordinary course of business apart from finished goods and those materials or supplies to be consumed in the production process or in the rendering of services. It is, thus, necessary for a company to ensure that each and every component of inventory is valued properly. The argument advanced by the company that it is difficult to ascertain the same in view of the multiple processes involved is not acceptable. Because, the Guidance Note on "Audit of Inventories" also recognises the likely difficulties in valuation of work-in-process and states that, "in general , the audit procedures regarding work-in-process are similar to those used for raw materials and finished goods. However, the auditor has to carefully assess the stage of completion of the work-in-process for assessing the appropriateness of its valuation. For this purpose, the auditor may examine the production / costing records (for example, cost sheets), hold discussions with the personnel concerned and obtain expert opinion, where necessary".

The argument that the opening and closing work-in-process would be more or less the same is also not justified because the omission of those would lead to distortion in true and fair view. Further, costs incurred for raw materials and the overheads would normally be different and would give rise to different value of opening and closing stock. The Guidance Note even requires the auditor to ascertain the system from which the value of work-in-process is obtained is reliable, and to examine subsequent records of production / sales.

Therefore, in view of the above, the auditor shall have to qualify the audit report in case work-in-process is not valued and shown in the financial statements.

(b) Existence of Internal Audit System: Para 4(A)(xv) of the CARO, 2003 issued under section 227(4A) of the Companies Act, 1956, requires a statutory auditor to comment whether the auditee company has an internal audit system commensurate with its size and nature of its business. This is, however, applicable only if the company has a paid-up capital exceeding Rs.50 lakhs as at the commencement of the financial year concerned or has an average annual turnover exceeding Rs.5 crores for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business.

In the instant case, the second condition is met and thus the auditor is required to make an inquiry whether the company has an internal audit system commensurate with its size and nature of its business. Since the internal audit system is not in existence, the auditor will have to mention the fact of not having such a system in his CARO Report. The fact that the company does not have an internal audit system commensurate with its size and nature of its business would also have repercussions on the normal audit procedures since the efficacy of internal control system would itself be questionable. Under the circumstances, apart from disclosing the fact of non-existence of the internal audit system in the report, the auditor should also modify substantive audit procedures as well.

(c) Observance of Accounting Standards: Prior to amendment of section 211 of the Companies Act, 1956, by the Companies (Amendment) Act, 1999, the contention of the company was correct that it was not required to follow accounting standards specified by the ICAI since these were mandatory only for the auditors. However, with the incorporation of sub-sections (3A), (3B) and (3C) in the section 211 of the Companies Act, 1956, by the amendment of the Act, every company is required to comply with the accounting standards as may be prescribed. Sub-section (3A) provides that every profit and loss account and balance sheet of the company shall comply with the accounting standards. Sub-section (3C) of section 211 provides that the standard of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be the Accounting Standards until the accounting standards are prescribed by the Central Government under this sub-section.

Thus with the commencement of the Companies (Amendment) Act, 1999, with effect from October 31, 1998, it is mandatory even for the company to follow the accounting standards while recording transactions in the books of account and preparing the financial statements. In fact, sub-section (3B) of section 211 requires that if the said standards are not complied with, it is obligatory on the part of the company to state deviations from the accounting standards, reasons for such deviation; and, the financial effect, if any, arising due to such deviations. The auditor is also required to express his opinion whether, in his opinion, the profit and loss account and balance sheet complied with the accounting standards referred to in sub-section (3C) of section 211.

(d) Declaration of Interim Dividend: Interim dividend can be declared by the Board of Directors only if there is an authorisation in the Articles of Association to do so. Quite often the advice of the auditor is sought before declaring an interim dividend. When this is done, he should suggest that an interim accounts should be prepared to ascertain the amount of profits that has been made. Assuming that interim accounts have been prepared and they disclose profits sufficient for the declaration of dividend after making appropriate provisions for depreciation, compulsory transfers to reserves, bad debts and other contingencies, only then the proportion of profits which have to be distributed as interim dividend may be decided.

Since the company has suffered a net loss at the end of the year, obviously the directors have miscalculated the performance of the company about the second half of the year. If the company had a sufficient balance in the profit and loss account as at the beginning of the year, the dividend declared could be paid out of the same. The balance had also to be sufficient to transfer the relevant amounts to reserves. In such a case the auditor need not report anything. Moreover, if such balance was not available, the dividend could also be paid out of reserves. In the situation of dividends to be declared out of reserves, a maximum of only 10% dividend is allowed. In this case, since the dividend was declared @ 30%, the said provisions would have been violated and thus the auditor would have to mention the said fact. If, however, there is no balance in the profit and loss account nor any reserves were available, the dividend would be clearly paid out of capital. The auditor would have to qualify his report mentioning the fact of the dividend having been paid out of capital.

(Note: Students may note that section 205 has been amended by the Companies (Amendment) Act, 2000. The term "dividend" henceforth includes "interim dividend" also. The provisions contained in sections 205, 205A, 205C, 206, 206A and 207 have been made applicable to interim dividend also.)

Question 3

Briefly describe the reporting requirements by a statutory auditor of a company for personal expenses of directors. *(6 marks) (Final May 2001)*

Answer

Reporting of Personal Expenses of Directors: Section 227 of the Companies Act, 1956, specifies the reporting requirements on the part of an auditor.

Under clause (e) of section 227(1A) of the Companies Act, 1956, the auditor has to make a specific inquiry whether any personal expenses have been charged to revenue account. The charging to revenue of such personal expenses, either on the basis of the company's contractual obligations, or in accordance with accepted business practice, is perfectly normal and legitimate and does not call for any special comment by the auditor. Where, however, personal expenses not covered by contractual obligations or by accepted business practice are incurred by the company and charged to revenue account, it would be the duty of the auditor to report thereon. If no such expenses are found, the auditor has no further duty to report that he is so satisfied. However, he would have to keep in his working papers adequate documentation that he had made such inquiries. Further, under para 4(A)(xix) of the MAOCARO, 1988 issued under section 227(4A) of the Companies Act, 1956 the auditor has also to report whether any personal expenses have been charged to revenue account and, if so, the details thereof have to be mentioned. Reporting under this clause is mandatory even if there are no personal expenses which have been charged to revenue. Though the requirement under section 227(1A) involved making an enquiry but the MAOCARO, 1988 extended this requirement that an auditor would not only make an enquiry but also report whether or not any personal expenses have been charged to revenue account. In most cases, however, the report under this clause generally states that no personal expenses have been charged except those payable under contractual obligations or in the normal course of business. Where, however, such expenses are not covered by contractual obligations or generally accepted business practice and are charged to revenue account, the auditor shall have to report in respect of such expenses.

(Note : The above requirements prescribed in MAOCARO, 1988 have been omitted in CARO, 2003 and has no more relevance).

Question 4

Comment on the following:

(a) The Accounting Standards issued by the Institute of Chartered Accountants of India need to be followed only by limited companies and not by partnership firms or proprietorships. *(4 marks)*

(b) For Excise Duty on finished goods in stock as at the end of the year, there is an option available to provide for the same or to show the same as a Contingent liability. *(4 marks)* (*Final May 2001)*

Answer

(a) Applicability of Accounting Standards: The Preface to the Statements of Accounting Standards clarifies that the Accounting Standards are issued "for use in the presentation of general purpose financial statements issued to the public by such commercial, industrial or business enterprises, as may be specified by the Institute from time to time and subject to the attest function of its members. The term 'General Purpose Financial Statements' includes balance sheet, statement of profit and loss and other statements and explanatory notes which form part thereof, issued for use of shareholders/ members, creditors, employees and public at large". As far as companies, whether limited or unlimited incorporated under the Companies Act, 1956 are concerned, all such companies are expected to adhere to specified accounting standards in terms of section 211(3A) of the said Act. Even otherwise, such a requirement seems to be implicit even in the absence of specific statutory provisions since the application of accounting standards is an integral component so as to ensure that the financial statements give a true and fair view. Accordingly, the compliance with accounting standards has to be examined by the auditors while auditing general purpose financial statements which are statutorily required to be audited under any law. Thus, compliance with accounting standards is required to be examined by an auditor in an audit of financial statements of individuals and non-corporate enterprises (viz., sole proprietary concerns, partnership firms, societies registered under the Societies Registration Act, trusts, Hindu Undivided Families, and associations of persons) only where the financial statements are statutorily required to be audited under any law. The accounting standards are also applicable to commercial, industrial or business activities of even charitable or religious organisations. Accounting Standards do not apply to those organisations whose entire activities are not of commercial, industrial or business nature, e.g., an organisation collecting donations to finance education of poor children. However, even if a very small proportion of the activities of an entity is commercial, industrial or business in nature, the accounting standards will apply to all its activities. Thus, the Council has made it clear that compliance with accounting standards required to be examined in an audit of financial statements of non-corporate enterprises only where the financial statements are required to be audited under any statutory enactment. For instance, in case there is no statutory requirement for such entities to prepare accounts on accrual basis, the auditor would not qualify but simply disclose the basis of accounting followed. Therefore, accounting standards are applicable not only to limited companies but also to partnership firms or proprietorships.

(b) Accounting Treatment of Excise Duty: The AS 2 (Revised) on, "Valuation of Inventories" states that finished goods are to be valued by taking into account the costs of purchase, costs of conversion and other costs incurred in bringing the inventories to the present location and condition. The costs of conversion to be included would be all direct factory overheads related to the said finished goods. Excise duty is a duty which is payable on the manufacture of the finished goods inside a factory. Though the collection of the same is deferred till the goods leave the factory, the liability for the same arises when the manufacture takes place.

The Institute, before the enactment of the revised AS 2, in its Guidance Note on Accounting Treatment for Excise Duty gave an option to entities to provide the excise duty payable on finished goods and add the same to the valuation of finished goods or not to make any provision but only make a disclosure of the said liability. After the revised AS 2 was issued effective from 1-4-1999, the ICAI revised its earlier guidance note and removed the alternative of not providing for the excise duty. Thus it is now mandatory for an entity to provide for liability for excise duty on finished goods lying in stock at the end of the year and add the same to the to the value of closing stock. According to Guidance Note on "Accounting Treatment of Excise Duty", excise duty should be considered as a manufacturing expense and like other manufacturing expenses be considered as an element of cost for inventory valuation. Where excise duty is paid on excisable goods and such goods are subsequently utilised in the manufacturing process, the duty paid on such goods, if the same is not recoverable from taxing authorities, becomes a manufacturing cost and must be included in the valuation of work-in-progress or finished goods arising from the subsequent processing of such goods. Further, where the liability for excise duty has been incurred but its collection is deferred, provision for the unpaid liability should be made. Excise duty cannot be treated as a period cost. Accordingly excise duty now cannot be shown as a contingent liability. Thus, it is now mandatory for an entity to provide for liability for excise duty on finished goods lying in stock at the end of the year and add the same to the value of closing stock. If the said provision is not made, the revised Guidance Note on Accounting Treatment for Excise duty says that the auditor should qualify his report and, if possible, also mention the quantum of the duty not so provided.

Question 5

As a statutory auditor of a Public Limited Company, how would you deal with the following situations?

(a) The company has sold some old machinery for Rs. one crore. The details of the cost of such machinery are not available since the entire records relating to fixed assets have been destroyed in an earthquake. (5 marks)

(b) The company had subscribed to shares of associate companies amounting to Rs.5 crores. These associate companies have incurred substantial losses and have been referred to BIFR for being declared as sick companies. The company does not want to make any provision for the fall in the value of the investments. (5 marks)

(c) As at the beginning of the year, the company has a capital of Rs.2.50 crores, free reserves of Rs.0.50 crore and Revaluation Reserve of Rs.4.50 crores. In the relevant year under audit the company has incurred a loss of Rs.4 crores. The company proposes to adjust the loss with the Revaluation Reserve. (6 marks) (Final May 2001)

Answer

(a) Sale of Machinery: AS 10 on "Accounting for Fixed Assets", gains or losses arising on disposal are generally recognised in the profit and loss statement. Therefore, when the company sells old machinery, profit/loss on sale thereof has to be determined. Such profit or loss can be determined provided the cost and written down value of the said machinery is available. In the instant case, since the entire records of fixed assets have been destroyed, the cost and the WDV of the machinery sold could not be arrived at. The company may therefore, have to determine the same on some estimated basis provided all reasonable efforts to determine the cost/WDVs of the machinery do not yield any better result. An all out attempt should be made by the management to reconstruct the old records. Such records may be constructed by obtaining old copies of annual reports distributed amongst shareholders, annual accounts filed with ROC, etc. In fact, through this process, the company shall be able to determine the WDV of the asset because the machinery sold seems to be quite big and must have been recorded on stand alone basis.

The auditor will have to see whether the estimate of cost and WDV arrived at in the above manner by the company is reasonable and whether the profit/loss is determined accordingly. A note to that effect would also have to be given by the management in the accounts. If the auditor is of the opinion that the said estimates are satisfactory based on available records and the note given by management explains the said fact, he may not qualify his report. If he is not so satisfied, he would have to give disclaimer in the audit report that in the absence of proper records, the said profit/loss has been arrived on an estimated basis and in that view he has been unable to form an opinion. As far as the report under the CARO, 2003 order is concerned, the auditor would have to point out that proper records of fixed assets showing full particulars as required by that clause are not available.

(b) Valuation of Investments: AS 13 on "Accounting for Investments" requires investments to be classified as long term and current investments distinctly in its financial statements. The investments in shares of associate companies can very well be considered as trade investments since they would not be intended to be liquidated within a period of one year from its acquisition. Hence they would be classified as long term investments.

AS 13 states, "long-term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually". In the instant case, these associate companies have incurred substantial losses and have been referred to BIFR for being declared as sick companies. The net worth of these companies would have been wiped out resulting in a fall in the value of the investments. Therefore, such fall cannot be merely temporary as the companies could take a long time to turn around (if at all) and again have a positive net worth. The auditor would therefore have to qualify his report by saying that no provision for diminution for fall in the value of investments as required by AS 13 has been made and to that extent the profits and reserves have been overstated.

(c) Adjustment of Loss against Revaluation Reserve: AS 10 on "Accounting for Fixed Assets" states that an increase in net book value of fixed assets is normally credited to owner's interest and under the heading Revaluation Reserves except that, to the extent that such increase is related to and not greater than a decrease arising on revaluation previously recorded as a charge to the profit and loss statement, it may be credited to the profit and loss statement. A decrease in net book value arising on revaluation of fixed asset should be charged directly to the profit and loss statement except that to the extent that such a decrease is related to an increase which was previously recorded as, credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to that account. The Guidance Note on Treatment of Reserve created on Revaluation of Fixed Assets states that where the value of fixed assets is written up in the books of account of a company, the corresponding credit appearing as revaluation reserve does not represent a realised gain and is, therefore, not available for distribution as dividend. Similarly, accumulated losses and the depreciation on the acquisition cost (including arrears of depreciation) should not be adjusted against revaluation reserve since this would amount to setting off actual losses against unrealised gains.

The auditor should explain to the management that accumulated losses cannot be adjusted against the revaluation reserve created on revaluation of the fixed assets. In case the company in question does so, the balance sheet of the company will not reflect a true and fair view of the state of affairs of the company keeping in view the magnitude of the amounts involved, i.e., accumulated losses amount to Rs.4 crores and share capital and reserves amount to Rs.3 crores (excluding revaluation reserve). If the management does not agree with the opinion of the auditor, the auditor may even issue an adverse report.

Question 6

As an auditor state your views on the following situations:

(a) Included under Current Assets of XYZ Ltd. is inventory aggregating to Rs.20 crores. A part of the said inventory manufactured for export had to be sold earlier at a discounted price off-shore due to moisture content present at the time of delivery. A part of similar inventory is included in Rs.20 crores. (5 marks)

(b) A construction company accounted for a contract entered into with a Government Department on completed contract method and that with a Private Sector Company on percentage of completion method. Both the contracts were for development of a township. (5 marks)

(c) X Ltd. entered into a contract with Y Ltd. to despatch goods valuing Rs. One lakh every month for six months upon receipt of entire payment. Y Ltd. accordingly made the payment. In 3rd month due to a natural calamity, Y Ltd. requested X Ltd. not to despatch until further notice.

X Ltd. accounted Rs. two lakhs as sales and transferred the balance to Advance Receipt against sales. *(5 marks)*

(d) XYZ Ltd. entered into a collaboration agreement with a U.S. based company to acquire knowhow for both manufacturing process and design, drawing of the factory at a total cost of Rs.10 crores. 75% of the knowhow cost was for design and drawings. XYZ Ltd. capitalised the cost of drawings, etc., with factory building and cost for manufacturing process with the cost of machinery. *(5 marks) (Final Nov 2001)*

Answer

(a) Valuation of Damaged Inventory: A part of the inventory exported earlier had to be sold at a discounted price off shore due to moisture content present at the time of delivery. The auditor will therefore have to examine what part of the inventory is included in the inventory valued at Rs.20 crores, a part of which had been exported at a discounted price. He will also have to satisfy himself that whether such part left with the company has also been damaged on account of moisture content. If required, the auditor may obtain a certificate from an expert about the condition of the inventory. Thereafter, it should be verified whether the principle of valuation enunciated in AS 2 (Revised) "Valuation of Inventories" have been followed in such a case. The standard requires that the inventories should be valued at the lower of cost or net realisable value. AS 2 (Revised) defines the net realisable value as the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. Accordingly, such part of inventory which is damaged should be valued at estimated realisable value if the same is lower than the cost. It may however, be noted that inventories are usually written down to net realisable value on an item-by-item basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write down inventories based on a classification of inventory, for example, finished goods, or all the inventories in a particular business segment. Thus, the auditor should ensure that such damaged inventories have been valued accordingly.

(b) Method of Accounting in case of Construction Contracts: AS 7 on "Accounting for Construction Contracts", recommends, as on date, two methods of accounting for contracts, viz., the percentage of completion method and the completed contract method. As per the facts given, the construction company has entered into two separate contracts for the development of township, one with the Government Department and other, with a private sector company. Regarding accounting treatment, the construction company had accounted for the contracts differently since the contract entered into with the government department was accounted for on Completed Contract Method and that with a private sector company on Percentage of Completion Method. AS 7 stipulates that, "it may be necessary for accounting purposes to combine contracts made with a single customer or to combine contracts made with several customers if the contracts are negotiated as a package or if the contracts are for a single project. Conversely, if a contract covers a number of projects and if the costs and revenues of such individual projects can be identified within the terms of the overall contract, each such project may be treated as equivalent to a separate contract". This, in accordance with Accounting Standard 7, a contractor may use different methods simultaneously for different contracts depending upon circumstances. However, AS 7 requires that when a contractor uses a particular method of accounting for a contract, then in that case for all other contracts that meet similar criteria, the same method is required to be used.

(c) Treatment of Advance Received Against Sales: AS 9 on "Revenue Recognition" specifies that revenue from sales should be recognised when the following conditions have been fulfilled:

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

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

In this case, X Ltd. had transferred the property in the goods at an agreed price and all significant risks and rewards. As such sale has been fully completed because upon receipt of the entire payment, X Ltd. was required to despatch goods valuing Rs.100,000 for six months out of its inventory. However, in the third month, Y Ltd requested to stop despatch until further intimation due to a natural calamity. X Ltd. recognised revenue to the extent the goods were despatched and transferred the balance payment received to Advance Receipt against Sales. X Ltd. had transferred the property in the goods at an agreed price and all significant risks and rewards. The delivery was to be effected as per the schedule indicated by Y Ltd. As per AS 9, "Revenue Recognition", mere postponement of delivery at buyer's request does not alter the period in which revenue should be recognised. Accordingly, X Ltd. should recognise the entire Rs.6,00,000 as Sales and pass necessary corrective entries.

(d) Treatment of Know-How Expenditure: AS 10, "Accounting for Fixed Assets" requires that know-how in general is recorded in the books only when some consideration in money or money's worth has been paid for it. Know-how is generally of two types:

(i) relating to manufacturing processes; and

(ii) relating to plans, designs and drawings of buildings or plant and machinery.

Know-how related to plans, designs and drawings of buildings or plant and machinery is capitalised under the relevant asset heads. In such cases, depreciation is calculated on the total cost of those assets, including the cost of the know-how capitalised. Know-how related to manufacturing processes is usually expenses in the year in which it is incurred. In accordance with AS 10, Accounting for Fixed Assets, XYZ Ltd. should have capitalised knowhow related to plans, design and drawings of buildings or plant and machinery, under the respective asset heads. It should be ensured that such cost has been capitalised under the relevant asset head only. Depreciation should have been calculated on the total cost of those assets, including cost of knowhow capitalised. Furthermore, knowhow expenses relating to manufacturing process should have been treated as an expense in the year in which it was incurred. Therefore, capitalising cost of manufacturing process with the cost of machinery is not proper.

Question 7

Y Ltd. Has accumulated losses of Rs.12 crores. The Reserves and Surplus of the said company also include "Share Premium Account" of Rs. 15 crores. The company intends to adjust the accumulated losses against the "Share Premium Account". Is the company permitted to do so under the provisions of the Companies Act, 1956? (6 marks) (Final Nov 2001)

Answer

Section 78 of the Companies Act, 1956 deals with the application of premium received an issue of securities (The word "securities" was substituted for the word "Share" by the Companies (Amendment) Act, 1999 w.e.f. October 31, 1998). Sub-section (1) of the said section provides that where a company issues shares at a premium, whether for cash or otherwise, the amount received as premium on such shares shall be transferred to an account called "Securities Premium Account" and the provisions of the Companies Act, 1956 relating to reduction of the securities capital of a company except as provided in the section shall apply as if the securities premium accounts were paid up securities capital of the company. Sub-section (2) of the said section provides that notwithstanding anything contained in sub-section (1), Securities Premium Account may be applied by the company for:

(a) Issue of fully paid bonus securities.

(b) Writing off of the preliminary expenses of the company.

(c) Writing off of expenses of the commission paid or the discount allowed on any issue of securities or of any debentures of the company.

(d) Providing the premium payable on the redemption of any redeemable preference securities or of any debentures of the company.

In view of the above provisions of the Companies Act, 1956, the company is not permitted to adjust its accumulated loss against the Share Premium Account.

Question 8

Write a short note on - Capital Reserves. (4 marks) (Final Nov 2001)

Answer

Capital Reserves: The expression 'reserve' has been defined in Part III of Schedule VI to the Act as not including "any amount written off or retained by way of providing for depreciation, renewals or diminution in the value of assets or retained by way of providing for any known liability". A reserve may be 'capital reserve' or 'revenue reserve'. The term "capital reserve" has not been defined in the Companies Act, 1956 except in a negative way in Part-III of Schedule VI to the Act. The expression "capital reserve" shall not include any amount regarded as free for distribution as dividend through the Profit and Loss Account. Capital reserve is created out of profits of a capital nature. Premiums issued on the issue of shares and debentures, profit made on redemption of debentures and the balance standing to the credit of forfeited shares account after re-issue of forfeited shares are some of the examples of capital reserve. In fact, capital reserves are in the nature of capital receipts which also cannot be distributed as dividends at all. AS 12, "Accounting for Government Grants" provides that where the grant relates to a non-depreciable asset, e.g., freehold land, and it has been decided that gross value of fixed asset should not be touched it should be generally be credited to capital reserve.

Question 9

As an auditor, state your view on the following:

(a) M Ltd. manufactures machinery used in Steel Plants. It quotes prices in various tenders issued by Steel Plants. As per terms of contract, full price of machinery is not released by the steel plants, but 10% thereof is retained and paid after one year if there is satisfactory performance of the machinery supplied. The company accounts for only 90% of the invoice value as sales income and the balance amount in the year of receipt to the extent of actual receipts only. (5 marks)

(b) A company had imported raw materials worth US dollars 2,50,000 on 15th January, 2002 when the exchange rate was Rs.46 per US dollar. The company had recorded the transaction at that rate. The payment for the imports was made only 15th April, 2002 when the exchange rate was Rs.49 per US dollar. However, on 31st March, 2002 the rate of exchange was Rs.50 per US dollar. The company passed an entry on 31st March, 2002 adjusting the cost of raw materials consumed for the difference between Rs.49 and Rs.46 per US dollar. (5 marks)

(c) A Public Company defaulted in the repayment of deposits together with interest on the due date for more than a year and the Chief Accountant contends that the auditor need not report on the default committed by the company (5 marks) (Final May 2002)

Answer

(a) Recognition of Revenue: AS 9 on 'Revenue Recognition', states that revenue from sale of goods should be recognised when the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership and no significant uncertainty exists regarding the amount of consideration. In the case of M Ltd., the goods, as well as the risks and rewards of ownership have been transferred to the steel plants. The invoice raised by M Ltd. is for the full price, but 10% less is received as the same is kept as 'Retention Money'. In this case, therefore, revenue has to be recognised at the full invoice price, i.e., 100% has to be accounted as Sales Income. Depending on the past experience of recovering the balance 10% from the steel plants, M Ltd. can, however, make a provision for sales income which is not likely to realised . In the absence of the above, the auditor will have to qualify his report.

(b) Changes in Exchange Rates: As per AS 11, "Accounting for the Effects of Changes in Foreign Exchange rates", Monetary items denominated in a foreign currency (e.g., foreign currency notes, balances in bank accounts denominated in a foreign currency, and receivables, payables and loans denominated in a foreign currency) should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from, or required to disburse, such item at the balance sheet date. Sundry creditors are monetary items. The AS requires that on every balance sheet date, monetary items denominated in foreign currency should be reported using the closing rate. In the instant case, having regard to the fact that the amount payable for the raw materials is a monetary item, the same would have to be shown in the balance sheet at the rate on the closing date of 31st March, 2002 i.e. Rs.50, irrespective of the payment for the same subsequently at a lower rate.

Hence the treatment given by the company is wrong and if the same is not rectified the auditor would have to qualify his report stating that AS 11 requirements were not followed.

(c) Default in Repayment of Deposits and Auditor's duties: The auditor's reporting requirements are contained in section 227 of the Companies Act, 1956. As far as requirements relating to de posits are concerned: CARO 2003, issued under section 227 of the Companies Act, 1956; and, clause (f) of Section 227(3) read with section 274 (1) (g) require auditor to specifically report on this aspect. Hence, The contention of the chief accountant is not correct. Under Clause (f) of section 227(3) of Companies Act, 1956 the auditor has to report whether any director is disqualified from being appointed as a director under clause (g) of sub-section (1) of section 274.

The relevant extracts of section 274(1) (g) referred to in clause (f) of section 227 (3) of the Companies Act, 1956 are as follows :

"A person shall not be capable of being appointed director of the company, if

(g) such person is already a director of public company which:

(A)--

(B) has failed to repay its deposits or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more; provided that such person shall not be eligible to be appointed as director of any other public company for a period of five years from the date on which such public company in which he is a director …………has failed to repay its deposits or interest or redeem its debentures on due date or pay dividend referred to in Clause B".

On a perusal of section 227(3)(f) it is apparent that the auditor has to report upon whether any of the directors of the public company, are disqualified from being appointed as a director in terms of clause (g) of sub-section (1) of section 274.

In addition, the CARO under section 227(4A) of the Companies Act, 1956 under Para (vi) has to state whether in case the company has accepted deposits from the public, whether the directives issued and the provisions of sections 58A, 58AA or any other relevant provisions of the Act and the rules framed there under, where applicable, have been compiled with. If contraventions should be stated; If an order has been passed by Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal whether the same has been complied with or not ?

In view of the above two situation, the auditor is required to make a report on defects committed by the company.

Question 10

(a) *Following is the data regarding six segments of Z Ltd.:*

(Rs. in '000s)

Particulars	*A*	*B*	*C*	*D*	*E*	*F*
Segment Revenue (Rs.)	*150*	*310*	*40*	*30*	*40*	*30*
Segment Result (Rs.)	*25*	*(95)*	*5*	*5*	*(5)*	*15*
Segment Assets (Rs.)	*20*	*40*	*15*	*10*	*10*	*5*

The Finance Director is of the view that it is sufficient that segments A and B alone be reported. Advise *(4 marks)*

(b) *Y Ltd. wishes to obtain a machine tool costing Rs.20 lakhs by way of lease. The effective life of the machine tool is 12 years but the company requires it only for the first five years. It enters into an agreement with R Ltd. for a lease rental of Rs.2 lakhs p.a.*

The Finance Director of Y Ltd. is not sure about the treatment of these lease rentals and hence requests your assistance in proper disclosure of the same. For calculation purposes, the implicit rate of interest may be taken at 15%. Discount factors : 0.87, 0.76, 0.66, 0.57 and 0.50. *(4 marks) (Final May 2002)*

Answer

(a) As per AS 17 on 'Segment Reporting', "a business segment of geographical segment should be identified as a reportable segment if:

(i) its revenue from sales to external customers and from transactions with other segments is 10% or more of the total revenue, external and internal of all segments, or

(ii) its segment result, whether profit or loss, is 10% or more of:

(a) the combined result of all segments in profit ; or

(b) the combined result of all segments in loss, whichever is greater in absolute amount; or

(iii) its segment assets are 10% or more of the total assets of all segments.

AS 17 also requires that if total external revenues attributable to reporting segments constitute less than 75% of the total enterprise revenue, additional segments should be identified even if they do not meet 10% criteria.

On the basis of the above the following conclusions emerge:

- Segmental Revenue – A and B will be reportable segments since both these segments 10% or more of total revenue i.e., Rs. 6,00,000
- Segmental Results – A, B and F will be reportable segments since the result of these segments is 10% or more than (Rs. 1,00,000) the combined results of segments in loss.
- Segment assets – A,B,C, D and E will be the reportable segments since there are 10% or more if total segmental assets i.e. Rs. 1,00,000. Hence all the segments have to be reported.

(b) The fair value of asset is Rs.20 lacs and the present value of lease rentals is 6.72 lacs. The machine is required for five years only which is less than 50% of the economic life. In view of having regard to substance of the transaction on both were courts, as per AS 19 on Leases, the lease will be classified as an operating lease. As per AS 19, the following may be disclosed:

Future minimum lease payments – Not later than 1 year	Rs. 2 lacs
Future minimum lease payments – Later than 1 year and not later than 5 years	Rs.4.98 lacs

Question 11

Write a short note on - Divisible profits. *(4 marks) (Final May 2002)*

Answer

Divisible Profits: Divisible profits are profits available for distribution to shareholders as dividends. It is different from book profit or economist's concept of profit. It represents those profits which are legally available for distribution as dividends. In the earlier years there were disputes whether depreciation should be provided before declaration of dividend or not; there were disputes whether capital profits or profits on revaluation of assets are available for distribution. Now these controversies stand resolved through the provisions of Companies Act, 1956 and also the judicial pronouncements over the years.

Section 205 prohibits a company from declaring dividends out of its profits before providing for depreciation in the manner laid down in the section. Depreciation should be provided as per rates/methods prescribed in Schedule XIV of the Act; not only for the year for which dividend is declared but also in respect of preceding financial year or years [since the commencement of Companies (Amendment) Act, 1960] for which adequate depreciation had not been provided in the books. If a loss has been incurred in the past which remains debited in the accounts then the amount of loss or the amount of depreciation whichever is less should be provided in the books before any dividend is declared. Under section 205(2A), the central government has the power to make rules regarding transfer of profits by a company to its reserves before any dividend can be declared.

Dividends may be declared out of the profits of the company for the current year after providing for depreciation. However, a company is required to transfer a prescribed percentage of its profits to reserves before declaring dividends. According to the rules framed by the central government in this regard, no dividend can be declared or paid by a company for any financial year out of its profits for that year unless it transfers a percentage of its profits for that year to reserve. The second source of dividends are the reserves created out of the undistributed profits of any previous financial years after providing for depreciation. Section 205A(3) of the Act provides that dividends can be declared out of the reserves only in accordance with the rules framed by the central government in this behalf. A declaration which is not in accordance with such rules can be made only with the previous approval of the central government. A company can also declare dividends out of the moneys provided by the central government or a State government for payment of such dividend in pursuance of a guarantee given by that government.

An auditor should be fully acquainted with all legal implications of dividends. Not only should be take into account the provisions of the Companies Act (specially Sections 205-208), but he should also consider the contractual and other legal obligations which determine the divisibility of profits. It cannot be over-emphasised that a dividend beyond what is legally permissible can give rise to legal action, since it would be construed as a payment out of capital. Hence, the first task of the auditor is to ensure that the dividends payable are within the legally permissible limits.

In ascertaining divisible profits, in the following circumstances, capital profits are included provided:

(i) the capital profits remain after a revaluation of all assets and liabilities;

(ii) the capital profit is realised in cash; and

(iii) the articles of association permits of such distribution.

Question 12

As a statutory auditor for the year ended 31st March 2002, how would you deal with the following:

P Ltd. has filed a petition in the High Court for adjustment of product development expenses of Rs.50 crores against the balance in Securities Premium account. While finalizing the accounts, the directors carried out the said adjustment since they were certain that the High Court approval would be received. The said petition has not come up for hearing till the date of signing of the accounts by the auditor. *(5 marks) (Final Nov 2002)*

Answer

Adjustment of Product Development Expenses Against Balance in the Securities Premium Account: Product development expenses are normally classified as revenue expenditure. They can in some cases also be classified as Deferred Revenue Expenditure. If it is classified as Deferred Revenue Expenditure, the same have to be written off to the profit and loss account over a reasonable period of time. In the instant case, the company adjusted the said expenses with the balance standing in the Securities Premium Account. Such an accounting treatment is not possible having regard to the normally acceptable accounting principles. However, any adjustment that is approved by the High Court will override the normally acceptable accounting principles. In the instant case, though the company has filed a petition in the High Court for carrying out the above adjustment, and though the directors are certain that the High Court would approve the adjustment, the said petition has not been finalised or approved by the High Court till the date of signing of accounts. In view of the same, the company cannot carry out the said adjustment. The statutory auditor, therefore, will have to qualify his report by stating that the product development expenses have been adjusted against the Securities Premium Account rather than treating them as the revenue expenditure and writing it off to the Profit and Loss Account. The statutory auditor would also have to mention the amount by which the profit for the year has been overstated.

[Students may refer Section 78 of the Companies Act, 1956 to specify the areas where the Securities Premium can be used]

Question 13

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

(a) *ABC Ltd., is a company engaged in the business of construction of roads and bridges. It follows completed contract method for all its projects and therefore revenue is recognised only when the contract is completed or substantially completed. For the year ended 31st March, 2001, the ABC Ltd., has earned a sum or Rs. 25 lakhs as interest on short-term deposits with their bank. These deposits are made out of advances received from the customers towards the projects that they are executing. ABC Ltd. while filing their Return of Income for the year 31st March, 2001 with the tax authority declared NIL income for that year. While calculating progress payments at the year-end, the interest of Rs.25 lakhs earned was considered as part of the funds received for the project. Is the treatment given by ABC Ltd. with regard to the interest earned on short-term deposit correct? (6 marks)*

(b) *XYZ Ltd., as part of overall cost cutting measure announced voluntary retirement scheme (VRS) to its employees, to reduce the employee strength. During the first half year ended 30.9.2002 the company paid a compensation of Rs.72 lakhs to those who availed the scheme. The Chief Accountant has reflected this payment as part of regular salaries and wages paid by the company. Is this correct? (6 marks)*

(c) *During the course of statutory audit of an investment company dealing in shares and securities, in spite of repeated reminders by the statutory auditor, the company officials did not provide the investments held by the company at the Balance Sheet date for* *verification and also did not provide the details for valuation of unlisted shares as on the Balance Sheet date. The statutory auditor, in his final audit report to the shareholders, reported as follows:*

"Subject to the verification of the existence and value of the investments, the Balance Sheet shows a true and fair view."

Is the report made by the Statutory auditor correct? (6 marks) (Final May 2003)

Answer

(a) Accounting Treatment of Interest on Short-term Deposits: As per AS 7, "Accounting for Construction Contracts" ABC Ltd. is free to use either Percentage of Completion Method or Completed Contract Method. Normally contractors who build highways, buildings, bridges and other structures, use the Percentage of Completion method since the projects they execute are completed over a long period of time. However, there is nothing wrong in adopting the Completed Contract Method by ABC Ltd. as per the accounting treatment permitted by the existing standard. Under the Completed Contract method, the costs and progress payments received are accumulated during the course of the contract but revenue is not recognised until the contract activity is fully or substantially completed. The interest of Rs. 25 lakhs earned by ABC Ltd., for the year ended 31st March 2001 is to be treated as 'income from other sources' and ABC Ltd. should declare that as income earned in their Return of Income for they ended 31st March 2001. Also as per AS 9, "Revenue Recognition" the interest earned on short term deposits cannot be treated as progress payments received for the contracts that are under progress and the interest earned should be recognised as revenue in the year in which it is earned.

(Note I: Alternatively, in case there exists a specific contract between ABC Ltd. and their customers that interest received on deposits made by them shall be adjusted towards the progress payments then the treatment accorded by the company is correct.

Note II: Candidates may note that the above answer is based on old AS 7 "Accounting for Construction Contracts", issued in 1985. The revised AS 7 comes into force in respect of all contracts entered during accounting periods commencing on or after 1.4.2003.)

(b) Accounting Treatment of Payment on account of VRS: As per AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" the payment made to its employees on account of VRS as an overall cost cutting measure would fall in the ambit of ordinary activities connected with the business of the enterprise. AS 5 requires that when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. In fact an activity like VRS can very well be treated as restructuring exercise carried by the enterprise. Though this is not an extraordinary item, AS 5 requires that items of income and expense which are not extraordinary items, the nature and amount of such items may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. Disclosure of such information is sometimes made in the notes to the financial statements.

Considering the above, the compensation of Rs. 72 Lakhs paid towards VRS availed by employees should be shown separately in the profit and loss account of XYZ Ltd., so that the effect of it on the operating results of the Company during the previous year can be perceived. Therefore, clubbing of Rs. 72 lakhs with the regular salaries and wages of the company by the Chief Accountant is not appropriate and, thus, the separate disclosure is necessary.

(c) Failure to Obtain Information and Explanation: The statutory auditor is required to express his opinion on the truth and fairness of financial statement audited by him only after examining the authenticity with reference to the information and explanations given to him. He must determine the extent of information which should be obtained by him before he expresses his opinion on the financial statement submitted to him for report. He should not express an opinion before obtaining the required data and information. In the given case, since the statutory auditor did not see the existence and also valuation of the investments held by the investment company the auditor, should not say "Subject to the verification of the existence and value of the investments, the balance sheet shows a true and fair view." In fact, as per facts given in the question, the auditor has not been able to obtain information and might not be able to satisfy himself by adopting other audit procedure and accordingly may have to appropriately modify the report. The auditor may state that because of these circumstances, he has been unable to form an opinion. But, reporting by the auditor that, "subject to verification of the existence and value of the investments, the balance sheet shows a true and fair view", the auditor is not providing information but only means to information. The situation in this case is analogous to London and General Bank's case. By reporting in the above manner auditor is not conveying any information. Rather, the auditor is arousing the suspicion of users of financial statements. Section 227(3) requires the auditor to specifically, state whether or not he has obtained all such information and explanation. If the auditor has not been able to obtain relevant information or explanations, he may have to qualify his opinion on the truth and fairness of the financial statements or express his inability to give an opinion in the matter. Thus the auditor has failed to perform his responsibilities

Question 14

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

(a) During the course of audit of ABC Ltd. it is noticed that out of Rs. 12 lakhs of provident fund contribution accounted in the books, only Rs. 2 lakhs has been remitted to the authorities during the year. On enquiry the Chief Accountant informed that due to financial problems they have not remitted but will remit the same as and when the position improves. (4 marks)

(b) National Tourism Ltd., a wholly owned Government Company approaches you to give a revised report on the revised accounts, as the original accounts has undergone changes consequent to the audit of Comptroller and Auditor General of India. (4 marks)

(c) M/s LNK's group gratuity scheme's valuation by actuary shows wide variation compared to the previous year's figures. (4 marks)

(d) In the books of accounts of M/s OPQ Ltd. huge differences are noticed between the control accounts and subsidiary records. The Chief Accountant informs that this is common due to huge volume of business done by the company during the year. (4 marks) (Final May 2004)

Answer

(a) Depositing Provident Fund Dues: The Companies Audit Report's Order, 2003 required the auditor to state whether the dues of provident fund have been regularly deposited with the appropriate authorities and, if not, the extent of arrears shall have to be indicated by the auditor. A company is required to deposit provident fund dues to appropriate authorities with in the period prescribed under the Rules governing it. In the case of fund constituted by the company, the company is required to follow provisions of section 418 of the Act. In this case there is a default in not depositing the provident fund contribution to the extent of Rs. 10 lakhs which is a lapse on the part of the company. The reason put forward by the Chief Accountant that the amount has not been deposited due to financial problems faced by the Company is no excuse for not remitting the provident fund. In fact, the company has not at all been regular in depositing the amount. Thus, the auditor shall include this in his report indicating the extent of arrears.

(Note: The Companies (Auditor's Report) Order, 2003 (now applicable) requires the auditor to comment upon the regularity aspects as also the extent of arrears in case the same has been outstanding for a period of more than six months. In the given case, it may be noted that M/s ABC Ltd. has failed to deposit the provident funds regularly and the major part of it has been outstanding for more than six months.)

(b) Auditor's Report on Revised Accounts: The Guidance Note on Auditor's Report on Revised Accounts of Companies Before Circulation to Shareholders deals with those situations wherein the statutory auditor is required to give report on the revised accounts. The auditors of National Tourism Ltd. have been asked to give revised report on the revised accounts as the original accounts have undergone changes consequent to audit of the C&AG. The Guidance Note requires that the statutory auditor must observe the following steps while issuing the revised report:

(i) All copies of the original accounts and reports thereon are returned to the auditor.

(ii) The adequate disclosure has to be made that the accounts which were earlier approved by the Board of Directors and reported by the auditors have been revised and re-approved by the Board of Directors as a specific note on the amended accounts.

(iii) In case the notes to accounts do not contain any note on revision or such a note is not considered adequate or comprehensive, the statutory auditor shall have to indicate that accounts have been revised based on the audit report of C&AG. The auditors at the time of issue of revised report has to bring these facts in his report if not included as a note in the revised accounts.

(v) Finally, the auditor's report (revised) should clearly draw the attention to their earlier audit report.

(c) Valuation by Actuary: SA 620, "Using the Work of an Expert" states that the auditor has to evaluate the work of an expert, say, actuary, before adopting the same. This becomes more crucial since M/s LNK's group gratuity scheme's valuation by actuary shows wide variation compared to previous year figures. There is no doubt that appropriateness, reasonableness of assumptions and methods used are the responsibility of the expert, but the auditor has to determine whether they are reasonable based on the auditor's knowledge of the client's business and result of his audit procedures. In the present case, the auditor must verify the reasonableness of assumptions made and methods adopted by the actuary in the evaluation particularly with reference to factors such as rate of return on investments, retirement age, number and salary of employees, etc. Accordingly, the auditor has to satisfy himself whether valuation done by the actuary can be adopted, otherwise he may report on his findings for wide variation.

(d) Difference Between Control Accounts and Subsidiary Records: The huge differences found between control accounts and subsidiary records in the books of M/s OPQ Ltd. indicate that there may be material misstatements requiring detailed examination by the auditor to ascertain the cause. The contention of Chief Accountant cannot be accepted simply because the company has done huge volume of business. Such a phenomenon indicates that recording of transactions is not being done properly or the accounting system in the company which might have several branches spread over the country fails to capture all transactions in time. It would also be interesting to see whether it is a recurring phenomenon or such reconciliation could not be done at a subsequent date. Having regard to all these circumstances, it appears from the facts of the case that these difference indicate the possibility of some kind of material misstatements. As per SA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements" when the auditor encounters circumstances that there is material misstatement, the auditor should perform procedures to determine whether the financial statements are materially misstated. If as a result of such examination the auditor comes across any material information involving fraud or gross irregularity the same shall be reported by him appropriately.

Question 15

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

Answer

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

(a) amounts in unpaid dividends accounts of companies;

(b) matured deposits with companies;

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

(d) matured debentures with companies;

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

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

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

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

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

Question 16

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

Answer

Application of Share Premium Account: Section 78 of the Companies Act, 1956 deals with the application of premium received on issue of shares. Sub-section (1) of the said section provides that where a company issues shares at a premium, whether for cash or otherwise, the amount received as premium on such shares shall be transferred to an account called "Share Premium Account" and the provisions of the Companies Act, 1956 relating to reduction of share capital of a company except as provided in the section shall apply as if the share premium account was paid up share capital of the company. Sub-section (2) of the said section provides that notwithstanding anything contained in sub-section(1), share premium account may be applied by the company for issue of bonus shares, writing off of preliminary expenses of the commission paid or discount allowed on any issue of shares or debentures of the company or for paying the premium on redemption of preference shares or debentures of the company. In view of these provisions of the Companies Act, 1956, it is not permitted to adjust its accumulated losses against the share premium account.

Question 17

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

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

Answer

(a) Appointment of Directors – Auditor's Duty: As per section 274(1)(g) of the Companies Act, 1956, a person is disqualified to be appointed as a director in case such person is a director of a public company which has not filed the annual accounts for any continuous period of three years; or such company has failed to repay its deposits or interest thereon on due date or pay dividend and such failure continues for one year or more.

Section 227(3)(f) of the Companies Act, 1956 requires the statutory auditor to state whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274. Further, the Department (now Ministry of Company Affairs) has also issued the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003. Rule 4 requires that the statutory auditors of both the appointing as well as the disqualifying company to:

(i) report under section 227(3)(f) of the Act to the members of the respective companies as to whether any director is disqualified from being appointed as a director under clause (g) of section 274(1) of the Companies Act, 1956; and

(ii) furnish a certificate every year as to whether on the basis of his examination of the books and records of the company, any director of the company is disqualified as a director or not.

The auditor is required to obtain written representation as to names of directors, particulars of appointment, default by the company, etc. As a part of audit procedures, the auditor is required to obtain the necessary information before giving his report. The auditor is required to obtain evidence in the form of written representation from a director in respect of each such company has not defaulted in terms of the section 274(1)(g). The written representation should also be noted and taken on record by the Board. The auditor should also verify the information provided by the management and direction from the information contained in the register mentioned u/s 303(1) of the Act. Accordingly, the auditor is required to report appropriately.

(b) Declaration of Interim Dividend: Section 205 of the Companies Act, 1956 permits declaration of interim dividend. Ordinarily based on the performance of the company and taking a conservative view, the Board of Directors of the company declare the interim dividends. Quite often the advice of the auditor is sought before declaring an interim dividend. When this is done, he should suggest that an interim accounts should be prepared to ascertain the amount of profits that has been made. Assuming that interim accounts have been prepared and they disclose profits sufficient for the declaration of dividend after making appropriate provisions for depreciation, compulsory transfers to reserves, bad debts and other contingencies, only then the proportion of profits which have to be distributed as interim dividend may be decided.

Since the company has suffered a net loss at the end of the year, obviously the directors have miscalculated the performance of the company about the second half of the year. If the company had a sufficient balance in the profit and loss account as at the beginning of the year, the dividend declared could be paid out of the same. The balance had also to be sufficient to transfer the relevant amounts to reserves. In such a case the auditor need not report anything. Moreover, if such balance was not available, the dividend could also be paid out of reserves. In the situation of dividends to be declared out of reserves, a maximum of only 10% dividend is allowed. If, however, there is no balance in the profit and loss account nor any reserves were available, the dividend would be clearly paid out of capital. The auditor would have to qualify his report mentioning the fact of the dividend having been paid out of capital.

Question 18

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

The accountant of C Ltd. has requested you, not to send balance confirmations to a particular group of debtors since the said balances are under dispute and the matter is pending in the Court.

(4 marks) (Final May 2005)

Answer

External Confirmation Requests: SA 505, "External Confirmations", establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. It requires that the auditor should employ external confirmation procedures in consultation with the management. The auditor may come across certain situations in which the management may request him not to seek external confirmation from certain parties because of dispute with the debtors, etc. The management, for example, might make such a request on the grounds that due to a dispute with the particular debtor, the request for confirmation might aggravate the sensitive negotiations between the entity and the debtor. In such cases, when an auditor agrees to management's request not to seek external confirmation regarding a particular debtor, the auditor should consider validity of grounds for such a request and assess management's integrity and obtain evidence to support the same. The auditor should also ask the management to submit its request in a written form, detailing therein the reasons for such a request. The auditor agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should document the reasons for acceding to the management's request and should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter. While considering the validity of request, in case the auditor reaches at a conclusion that the same was not valid, he may appropriately modify the report.

Question 19

Answer the following:

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

Answer

Section 209(1) of the Companies Act, 1956 requires that every company shall keep proper books of account with respect to the following items:

(i) all sums of money received and expended by the company and the matters in respect of which the receipts and expenditure take place;

(ii) all sales and purchases of goods by the company;

(iii) the assets and liabilities of the company; and

(iv) in the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilisation of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particulars in the books of account.

Proper books of account shall not be deemed to be kept if such books of accounts are not kept on accrual basis of accounting and according to double entry system of accounting.

In case proper books of account are not kept, the auditor is required to specifically refer to violation of the Companies Act, 1956 in the auditor's report and shall also state that in his opinion proper books of account as required by law have not been kept by the company so far as appears from his examination of those books and, he has to further give either qualified opinion or disclaimer of opinion.

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

Question 20

Briefly describe the Auditor's responsibilities regarding disqualification of Directors.

(8 marks) (Final Nov 2001)

Answer

Auditor's Responsibilities regarding Disqualification of Directors: Section 227(3) of the Companies Act, 1956 has recently been amended by the Companies (Amendment) Act, 2000 whereby clauses (e) and (f) have been inserted. Clause (f) now inserted requires an auditor to comment 'whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274. The relevant extracts of section 274(1)(g) referred to in clause (f) of section 227 (3), are reproduced below:

"274(1) A person shall not be capable of being appointed director of a company, if–

………………………………………………………………………………………

………………………………………………………………………………………

(g) such person is already a director of a public company which –

(A) has not filed the annual accounts and annual returns for any continuous three financial years commencing on and after the first day of April, 1999; or

(B) has filed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more;

Provided that such person shall not be eligible to be appointed as a director of any other public company for a period of five years from the date on which such public company in which he is a director failed to file annual accounts and annual returns under sub-clause (a) or has failed to repay its deposit or interest or redeem its debentures on due date or pay dividend referred to in clause (B)."

Section 274(1)(g) is applicable to appointment of directors both in public and private companies but the reporting will be limited to those directors of a company who are also directors of any public company. It may be further noted that a person who was a director of a public company which had defaulted in terms of clause (g) of section 274(1) and ceased to be a director of that public company would not be disqualified from being appointed as a director of a private company since on the date of appointment, he is not director of such public company and moreover proviso to section 274(1)(g) is only applicable to appointment of such director in another public company.

A person is disqualified from being appointed as a director of a company, where any public company of which also he is a director, has not filed annual accounts and annual returns for any continuous three financial years commencing on and after 1.4.1999 or has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more. In case of a disqualification by virtue of sub-clause (A) of clause (g) of section 274(1), the period of five years would be reckoned from the date as specified in sub-clause (A), on which the public company failed to file its annual accounts and annual returns. Where the disqualification arises on account of sub-clause (B) of clause (g) of section 274(1), the period of five years will be reckoned from the relevant due date as specified in sub-clause (B) for repayment of deposit or interest thereon or redemption of debentures or payment of dividend, as the case may be.

Section 303(1) of the Companies Act, 1956 requires every company to keep a register of directors, etc. at its registered office. The said register contains various particulars relating to all the directors of the company including particulars in respect of the office of director, managing director, etc. held in any other body corporate(s) by each director.

In case an auditee company happens to be a public company which has not filed the annual accounts and annual returns for any continuous three financial years commencing on and after 1st April, 1999; or has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more; then the auditor must report that all the directors are disqualified from being appointed as director in terms of clause (g) of sub-section (1) of section 274 of the Act.

Question 21

Write short notes on the following:

(i) *Consolidated Financial Statements* *(Final- Nov 2000)*

(ii) *Audit Committee* *(Final- Nov 2000, Nov 2002)*

(iii) *Remuneration to Statutory Auditors under the Companies Act, 1956.* *(Final May 2006)* (4×3=12 marks)

Answer

(i) Consolidated Financial Statements

Consolidated financial statements are the financial statements of a group presented as those of a single enterprise. The consolidated financial statements provide the users of financial statements an overall picture of the holding company and its subsidiaries. Consolidated Profit and Loss Account gives the overall profitability of the group after adjustment of unrealised profit involved in mutual transactions and decomposition of profit of the subsidiaries into capital and revenue. Similarly, Consolidated Balance Sheet shows the unified state of affairs of the group after adjustment of mutual indebtedness and putting separately the minority interest. Thus the overall financial health of the holding company can be judged using Consolidated Financial Statements. Those who want to invest in the shares of the holding company or acquire it need such consolidated statement for evaluation. Thus, in many developed countries like USA, UK, Germany, France etc., the consolidation of financial statements is compulsory. At present in India preparation of consolidated financial statements is a legal necessity. The ASB of the Institute has issued "Accounting Standard on Consolidated Financial Statements" SA 250, which came into effect in respect of accounting periods commencing on or after 1st April, 2001 and mandatory in nature. The objective of this Statement is to require parent (also known as holding) enterprises to provide financial information about the economic activities of their groups by preparing consolidated financial statements. These statements are intended to present financial information about a parent enterprise and its subsidiary enterprises as a single economic entity to show the economic resources controlled by the group, the obligations of the group and results the group achieves with its resources. Accounting Standard - 22 lays down in detail the consolidation procedures and disclosure requirements.

(ii) Audit Committee

An audit committee is a committee of the board of directors of a company entrusted with the task of overseeing the financial process of the company. This committee will consider various issues relating to the audit functions and review the company's financial and risk management policies. Audit committees have received wide publicity and there is a growing awareness of the benefits of these committees. That an effective audit committee can make a significant contribution to the financial reporting process of a company has been well recognised. Though an audit committee may be considered as an extended arm to assist in accomplishing board's objectives, it has very strong impact on all major groups related to the financial reporting process, viz., the board of directors, the managerial personnel and the independent auditor.

Primarily, an effective audit committee is a positive step as it strives to enhance the credibility and integrity of financial statements. In this process, the following related benefits accrue as well:

(i) It helps board of directors to discharge their ever-increasing responsibilities in an efficient and effective manner with due care and diligence. Thereby, it reduces the burden of top management.

(ii) It facilitates greater personal involvement by directors' especially non-executive directors in financial and audit aspects of the company.

(iii) An effective committee is also concerned to determine whether or not to appoint statutory auditor for non-audit services as well. Thus, it reinforces the auditor's independence in general.

(iv) By monitoring and evaluating the results of internal audit, it can suggest overall improvement in the internal controls.

(v) By an objective review of management's financial policies including accounting policies and operations, it provides a stimulus for optimal performance by the management.

The formation of an audit committee is a relatively simple matter, but rendering it effective is more complex. A single most important factor is the attitude of the top management towards such committees. The success of a committee depends upon the selection of members who are not only competent enough to deal with technical matters but should also have enough time to devote in order to fulfil their role. This may also lead to increase in costs.

Note:[Not a part of the Answer]

Section 292A of the Companies (Amendment) Act, 2000 applicable w.e.f. 13-12-2000 provides for constitution of audit committees is reproduced below for the information of students.

(i) Every public company having paid-up capital of not less than five crores of rupees shall constitute a committee of the Board known as "Audit Committee" which shall consist of not less than three directors and such number of other directors as the Board may determine of which two-thirds of the total number of members shall be directors, other than managing or whole-time directors.

(ii) Every Audit Committee constituted under sub-section (1) shall act in accordance with terms of reference to be specified in writing by the Board.

(iii) The members of the Audit Committee shall elect a chairman from amongst themselves.

(iv) The annual report of the company shall disclose the composition of the Audit Committee.

(v) The auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the Audit Committee but shall not have the right to vote.

(vi) The Audit Committee should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review the half-yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems.

(vii) The Audit Committee shall have authority to investigate into any matter in relation to the items specified in this section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary.

(viii) The recommendations of the Audit Committee on any matter relating to financial management, including the audit report, shall be binding on the Board.

(ix) If the Board does not accept the recommendations of the Audit Committee, it shall record the reasons therefor and communicate such reasons to the shareholders.

(x) The Chairman of the Audit Committee shall attend the annual general meetings of the company to provide any clarification on matters relating to audit.

(xi) If a default is made in complying with the provisions of this section, the company, and every officer who is in default, shall be punishable with imprisonment for a term which may extend to one year, or with fine which may extend to fifty thousand rupees, or with both.

(iii) Remuneration to Statutory Auditors under the Companies Act, 1956: The company auditor's remuneration is fixed by:

(i) directors when the first auditors are appointed or to fill a casual vacancy (other than the one caused by resignation of the auditor);

(ii) Central Government when the appointment is made by it; and

(iii) company in general meeting or in such other manner as the company in General meeting may determine (including those wherein the auditor is appointed by the C&AG of India u/s 619 of the Act.)

It is further provided that any sums paid by the company in respect of the auditor's expenses shall be deemed to be included in the expression 'remuneration'. This implies that where a fixed sum is approved as remuneration of the auditor, it includes his expenses. However, it is not necessary that the amount of remuneration is specified by the company in its general meeting. It would be enough if the manner in which the remuneration is to be fixed is laid down in the general meeting. It is also not essential that the remuneration is fixed in the same general meeting in which the auditor is appointed.

Disclosure Requirements Under Companies Act, 1956: As per the Profit and Loss Account under Schedule VI to the Companies Act, 1956, the remuneration may be disclosed to the auditors in the following manner:

(a) As auditor

(b) As adviser or in any other capacity in respect of:

  (i) taxation matters

  (ii) Company Law Matters, and

  (iii) Management Services

(c) The amounts paid in any other manner.

Question 22

Write a short note on - Personal Expenses of Directors. (4 marks) (Final May 2003)

Answer

Personal Expenses Of Directors: Payments to directors by way of remuneration and perquisites are required to be authorised in accordance with sections 198 and 309 of the Companies Act, 1956. Depending upon the requirements of Articles of Association of the company, the remuneration may require sanction of the shareholders either by special resolution or ordinary resolution or only approval of the Board. If terms of appointment include payment of expenses of personal nature then the company can incur such expenses. If there is no provision to incur personal expenses and if such expenses are incurred, then it is the duty of the auditor to point out such expenses in the report. Reporting requirements "the requirement of identifying and reposting on personal expenses" has been dispensed with in CARO, 2003.

Question 23

Answer the following:

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

Answer

Compliance with Requirements of Companies Act, 1956: When one of the joint auditors of the previous year is appointed as the sole auditor for the next year, it is similar to new re-appointment of one of the retiring joint auditors. The provisions of section 225 of the Companies Act, 1956, relating to non-reappointment of the other person also need to be considered. The following points should be taken into account:

(i) Special notice u/s 225(1) was duly received by the company from a member at least 14 days before AGM containing a proposal for appointing a sole auditor expressly.

(ii) Verify notice sent to all the members at least 7 days before the AGM. [u/s 190(2)]

(iii) Verify that special notice has been sent to retiring auditor forthwith. [u/s 225(2)]

(iii) Any representation received from the retiring auditor was sent to the members [u/s 225(3)].

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

(v) Examine that proposed resolution was properly passed.

(vi) Ensure that provisions of section 224(2) are complied fully.

(vii) Ascertain special resolution u/s 224A, if any, is passed accordingly.

(viii) Obtain a certified copy of the relevant minutes of AGM and a written communication of the appointment within 7 days.

Question 24

Comment on the following:

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

Answer

Section 228 of the Companies Act, 1956 requires that the accounts of a branch office of a company are required to be audited either by the company's auditor or by any other person qualified for appointment as auditor of the company. So, normally speaking, the audit of branch office has to be carried out unless the company has obtained exemption under the Companies (Branch Audit Exemptions) Rules, 1961 formulated u/s 228(4), having regard to quantum of activity. The Rules provide for the exemption of a branch office of a company carrying on manufacturing, processing or trading activity from the provisions of section 228, if the average quantum of activity of the branch does not exceed rupees two lakh or two per cent of the average of the total turnover and the earnings from other sources of the company as a whole, whichever is higher. Since in the instance case, no such exemption has been obtained and accordingly, the company is liable. The auditor is also required to mention this fact in the audit report and deal appropriately.

Question 25

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

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

Answer

(a) Branch Auditor's Report: As per provisions of the Companies Act, 1956, the accounts of a branch office of a company are required to be audited either by the company's auditor or by any other person qualified for appointment as auditor of the company. It is not necessary for branch auditor M/s XYZ to visit the branch and conduct the audit only at branch's premises. It is a matter of professional judgement for the branch auditor to decide as to whether he needs to visit the branch. At the same time, the statutory auditor has the right to visit branch offices and to have access to the books of accounts and vouchers maintained at the branch office in this case.

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

Question 26

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

ABC Ltd. having a paid up capital of Rs. 1 crore earned as total net profit of Rs. 1 crore for the years 2001-02 to 2003-04. The Company did not declare any dividend nor transferred any amount to Reserves for these years. The entire profit was retained in the Profit & Loss Account. In 2004-05, the company made a profit of Rs. 20 lacs. The company also proposed in 2004-05 to declare dividend @25% out of accumulated profits. (4 marks)(Final May 2006)

Answer

Declaration of Dividends: ABC Ltd. earned a total net profit of Rs.1 crore for three years 2001-02 to 2003-04 but it did not declare any dividend nor transferred any amount to Reserves for these three years. Since it did not declare any dividend, there was no compulsion to transfer any amount to Reserves. It appears that the company has retained the profit of previous years as "surplus" under the heading of "Reserves & Surplus". ABC Ltd. wants to declare dividend of Rs. 25 lacs for the financial year 2004-05, which works out to 25% of its paid up capital. However, since this rate of dividend exceeds 20% of the paid up share capital, as per the requirements of Companies (Transfer of Profit to Reserves) Rules, 1975, the company should transfer at least 10% of its current profit that is Rs.2 lacs to reserves resulting into deficiency of Rs. 7 lacs in the amount of current profit which could be available for the purpose of distribution of dividend.

The company, however, is well within its power to cover the said deficiency of profit out of its accumulated profit in spite of restrictions laid down in the rules prescribed under section 205A (3) of the Act, viz., Companies (Declaration of Dividend out of Reserves) Rules, 1975, since the company had not transferred any of its profit for the years 2001-2002 to 2002-04 to reserves. Thus, the company is well within its powers and right to declare the dividend of Rs.25 lacs for the year 2004-05.

Question 27

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

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

(5 marks)

(b) Apex Ltd., a well reputed manufacturing public limited company has made a contribution of Rs. 2.5 lacs during the financial year ended 31.3.06 to a political party for running a school, situated in the village, where most of the workers of the company reside. It is admitted that the benefit of the school is mostly for the children of the workers of the company. The company has not made any profits in the last four years.

(4 marks)(Final Nov 2006)

Answer

(a) Disqualification of auditors: The guidance note on "Independence of Auditors" issued by the ICAI in this context recommends that "a question of indebtedness may also be raised where an auditor of a company purchases goods or services from the company audited by him. In such a case, if the amount outstanding exceeds Rs. 1000, irrespective of the nature of the purchase or period of credit allowed to other customers, the provisions concerning disqualification of auditor as contained in sec 226 (3) (d) will be attracted. This is applicable in the case of purchase of air tickets for personal work by the auditor of a company on normal terms and conditions of the business of the company as the amount outstanding at the end of the year exceeded Rs. 1000. Therefore, the contention of Mr. Rajesh that he does not incur disqualification is not correct as he has purchased a ticket of the value of Rs. 18,000. The provisions concerning disqualifications of auditor as contained in Sec 226 (3) (d) will be attracted.

(b) Restrictions regarding political contribution: Section 293-A of the Companies Act 1956 deals with prohibitions and restrictions regarding political contribution. A non-Government company which has been in existence for not less than three years may contribute any amount or amounts directly or indirectly to any political party or for any political purpose to any person provided that the aggregate of the amounts which may be so contributed by a company in any financial year shall not exceed 5% of its average net profits determined in accordance with the provisions of Sections 349 and 350 during the three immediately preceding financial years. The company in question has not made any profit in last four years and contributed Rs. 2.5 lacs during the year to a political party for running a school. This is violation of the provisions of Section 293-A of the Companies Act although the children of its workers are benefited. The auditor would have to qualify his report stating the contravention of the provisions of the Companies Act.

Question 28

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

(a) In the audit of ABC Private Limited, auditor came across cases of payments to Directors, whereby, expenses of a personal nature were reimbursed. (5 Marks)

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

(4 Marks) (Final May 2007)

Answer

(a) Reimbursement of personal expense of Director: All payments to Directors as remuneration or perquisites whether in the case of a public or private company are required to be authorised both in accordance with the Companies Act and Articles of Association of the company. Articles may provide that such remuneration require sanction of the shareholders either by ordinary or special resolution while in some cases it may require only approval of Directors. If the terms of appointment of a Director include payment of expenses of a personal nature, then such expenses can be incurred by the company; otherwise, no such expense can be incurred or reimbursed by the company. In the instant case the auditor has to ensure that the above is complied with, without which, if such expenses are paid, he has to disclose the fact in his report, as also in the accounts. In this regard attention is invited to section 227 (1A) (e) of the Companies Act wherein auditor has to inquire into whether personal expenses have been charged to revenue. However, reporting requirements "the requirement of identifying and reposting on personal expenses" has been dispensed with in CARO, 2003.

(b) Provision for proposed dividend: As per the ICAI's Guidance Note, proposed dividend does not represent a liability, nor does it amount to a provision, pending the approval of the share holders in the general meeting.

Though the format given in schedule VI requires proposed dividend to be shown under 'Current Liabilities and Provisions', it does not mean in fact that the proposed dividend becomes a liability or is necessarily a provision. Part 1 of Schedule VI that prescribes the form of balance sheet requires " proposed dividend' to be shown under 'Provisions' and paragraph 3(xiv) of Part II of the same Schedule requires specific disclosure of the proposed dividend.

It is recommended, that if no appropriation is made, shareholders' attention should be drawn to such fact and the amount should be quantified. The fact that provision for proposed dividend has not been made should be disclosed by means of a note in the accounts. The auditor should refer to the note in his report and make his report subject thereto.

Question 29

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

Answer

(a) Amendment of accounts after the completion of the audit and adoption of the Accounts by the Board before circulation to the shareholders: This pertains to the manner in which the statutory auditor should report upon amended accounts. The Companies Act does not contemplate the revision of accounts and a further report by the statutory auditor on the amended accounts. At the same time, it is entirely within the competence of the Board of Directors to amend the accounts and resubmit the same to statutory auditors for report before the accounts are placed before the annual General Meeting. The report issued by the statutory auditor on such amended accounts will be in substitution of the report issued before the amendment. Unless all copies of the original accounts and reports are returned to the auditor, such substitution is not possible.

The guidance on Auditor's report on revised accounts of companies before circulation to shareholders recommends that members, when called upon to issue a report on amended accounts for the same period due to amendments to the accounts, should ensure all copies of the original accounts and reports are returned to him, adequate disclosure about the revision of accounts already reported, appears as a specific note on the amended accounts. If the Statutory auditor is satisfied about the adequacy of disclosure, there may not be any need for him to refer to the revision of balance sheet and/or the profit and loss account in his report otherwise he has to refer to the revision in his report.

Question 30

(a) What are the important aspects to be looked into a due diligence review of Cash flow?

(8 marks) (Final Nov 2007)

(b) What is the meaning of "Small and Medium sized Company" as per the Companies (Accounting Standards) Rules, 2006? (8 marks) (Final Nov 2007)

Answer

(a) Due Diligence review of cash flow

(i) Review the historical pattern of cash flows of the organization and look for change in trends.

(ii) See whether the company is able to meet its cash requirements from internal generations/accruals or does it seek outside sources from time to time.

(iii) Check whether the company honours its commitments to creditors, Government and other stock holders.

(iv) Verify the ability of the company to turn its stock into Debtors i.e. sale ability of its products.

(v) Ensure that the company follows up with Debtors and that the Debtors collection period is not very large.

(vi) Check the ability of the company to deploy its funds in profitable investment opportunities.

(vii) Look into the investment pattern of the company, whether they give maximum benefits to the company and are easily realizable.

(b) In exercise of the powers conferred by clause (a) of sub-section (1) of section 642 of the Companies Act, 1956 (1 of 1956), read with sub-section (3C) of section 211 and sub-section (1) of section 210A of the said Act, the Central Government, in consultation with

National Advisory Committee on Accounting Standards, made the Companies (Accounting Standards) Rules, 2006. As per these rules "Small and Medium Sized Company" (SMC) means, a company-

(i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank, financial institution or an insurance company;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Explanation: For the purposes of this a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Question 31

Write a short note on - Supplementary Audit u/s 619(4) of the Companies Act, 1956.

(4 marks) (Final Nov 2007)

Answer

Supplementary Audit u/s 619(4) of the Companies Act, 1956: The auditor of a Government company shall be appointed or re-appointed by the Comptroller and Auditor-General of India . The auditor aforesaid shall submit a copy of his audit report to the Comptroller and Auditor-General of India who shall have the right to comment upon, or supplement, the audit report in such manner as he may think fit. Any such comments upon, or supplement to, the audit report shall be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

Question 32

Elaborate under Clause 49 of the Listing Agreement, who is an Independent Director.

(6 marks) (Final May 2008)

Answer

Clause 49 of the listing agreement on Independent Director: As per Clause 49 of the listing agreement, an Independent Director shall mean a non-executive director of the company who:

(i) apart from receiving director's remuneration, does not have any material pecuniary relationship or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiary(s) and associates which may affect independence of the director;

(ii) is not related to promoters or persons occupying management positions at the board level or at one level below the Board;

(iii) has not been an executive of the company in the immediately preceding three financial years;

(iv) is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:

 (a) The statutory audit firm or the internal audit firm that is associated with the company, and

 (b) The legal firm(s) and consulting firm(s) that have a material association with the company.

(v) is not a material supplier, service provider or customer or a lessor or lessee of the company which may affect independence of the director and

(vi) is not a substantial shareholder of the company i.e. owning two per cent or more of the block of voting shares.

Question 33

As a Statutory Auditor, how would you verify advances against Goods?

(8 marks) (Final May 2008)

Answer

Verification of advances against goods(Banking Companies):

(i) *Sanction:* Examine the sanction letter, letter of hypothecation and note the important terms and conditions of the advances.

(ii) *Stock statements:* Verify the quantity and value of goods hypothecated based on the stock statements received from the borrower. Test check the Godown Register and examine the valuation of goods to ascertain the reasonableness of the same.

(iii) *Inspection:* Ascertain as to whether the premises of the borrowers are periodically visited by the bank officials to verify the quantity as per the periodic stock statements.

(iv) *Stock Audit:* See whether the bank has got a system of obtaining stock and receivables audit report in respect of such advances. If so, review the stock audit report and identify adverse comments, if any.

(v) *Hypothecation/Pledge:* Examine the letter of hypothecation and certificate of registration of charge, in respect of goods pledged with the bank.

(vi) *Insurance:* Examine the insurance policies for their validity, adequacy etc. and see that policies are in favour of the bank.

(vii) *Documents of title:* Inspect the documents of title to goods like bill of lading, dock warrant, railway receipts etc to ensure that they are endorsed registered in favour of the bank.

(viii) *Third party certificate:* Where the hypothecated goods are in possession of third parties, such as clearing and forwarding agents, transporters, bankers, etc. undertaking has been obtained by the bank that they will handover the goods or sale proceeds thereof to the bank only. In such cases, certificate should be obtained by the bank from such third parties regarding quantities on hand, on balance sheet date. The valuation of such goods should be checked by the auditor.

Question 34

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

Answer

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

1. Ceiling limit: Ensure that a certificate has been issued u/s 224 of the Companies Act, so that the total number of company audits held by the firm (including the new appointment) will not exceed the specified number.
2. Resolution at AGM: Verify that at AGM of the Company, a proper resolution is passed. Inspect general meeting minutes book to see that the appointment is duly recorded.
3. Compliance with law: Satisfy that the legal procedure contemplated in Sections 224 and 225 of the Companies Act, dealing with removal of existing auditor, if required, has been followed. Also see whether Section 224A (provision of special resolution in case of companies in which not less than 25% of the subscribed capital of the Company is held by public financial institutions or Government Companies) and Section 619B (in case of a company in which not less than 51 % of the paid up share capital is held by Central / State Government - C&AG appointment) are attracted and complied with.
4. Code of conduct: Communicate with the previous auditor, if any, to ascertain if there are any professional reasons for not accepting the appointment.

Question 35

What are the duties of an auditor regarding disqualification of directors under Section 274(1)(g) of the Companies Act, 1956? (8 marks) (Final Nov 2008)

Answer

Clause (g): of sub section (1) of section 274 of Companies Act, 1956 states:

A person shall not be capable of being appointed as director of company if:

Such person is already a director of a public company which -

(A) has not filed annual accounts and annual returns for any continuous three financial years commencing on and after first day of April, 1999 or

(B) has failed to repay its deposits or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more.

Provided such a person shall not be appointed as director of any other public company for a period of five years from date on which such public company where he is director has failed to file annual accounts or returns or has failed to repay deposits or redeem debentures on due date or pay dividend.

Auditor is required to report under section 227 (3) (f) of the Companies Act,1956 to members of respective companies whether any director is disqualified from being appointed as director under clause (g) of section 274 (1) of the Companies Act, 1956 and

Furnish certificate every year as to whether on the basis of his examination of the books and records of the company any director of the company is disqualified as a director or not.

Auditor to comply with section 227 (3) (f) should obtain a written representation as to:

(a) Names of directors of company during period covered by auditor's report

(b) particulars of appointment /resignation of such directors

(c) Submission of form DD-A, required to be submitted by such director.

(d) Information of directors contained in register maintained under section 303(1) of Company's Act as update up to date of balance sheet.

(e) Details of default committed by company under section 274(1).

(f) If company has committed any default, whether form DD-B submitted by company on the basis of such examination, auditor is required to furnish certificate every year stating whether any director is disqualified for appointment as director.

Question 36

You have been asked by a company to compile financial statements for the purpose of obtaining loan from a Bank. Draft a report to be given to the Management for the same.

(8 marks) (Final Nov 2008)

Answer

Draft of a Report of an Engagement to Compile Financial Statements - SRS 4410

To............

On the basis of the accounting records and other information and explanations provided to us by the Management, we have compiled the unaudited Balance Sheet of_______ (Name) as at______(date) and the related Profit & Loss Account for the period then ended.

The management of the__________ (Name) is responsible for:

(a) Completeness and accuracy of the underlying data and complete disclosure of all material and relevant information to the accountant;

(b) Maintaining adequate accounting and other records and internal controls and selecting appropriate accounting policies;

(c) Preparation and presentation of financial statements in accordance with applicable laws.

(d)………………….

(e)…………………….

The compilation engagement was carried out in accordance with SRS 4410 issued by ICAI.

The Balance sheet and the Profit & Loss Account are in agreement with the books of accounts. We have not audited or reviewed these financial statements and accordingly express no opinion thereon.

For_______________

Chartered Accountants.

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AUDIT REPORT

Question 1

Write a short note on - Summary Written Report. *(4 marks) (Final May 2000)*

Answer

Summary written reports: These are known as flash reports. They are significant highlights for immediate attention of top management. Generally suspected defalcations are reported briefly to the appropriate management official on the 'flash' basis, often ending up in referral for criminal investigation and legal action. It is common practice in number of companies of issuing a report quite frequently summarising the various individual reports issued and describing the range of their contents in a very brief and comprehensive manner where only important points are highlighted. Such reports are primarily issued for audit committees of Board of Directors and for other top level managers who do not have sufficient time to go through the elaborate reports and matters which are required to be brought to their notice for immediate action.

Question 2

(a) H.W.P. Private Ltd. is having only two members H and W. During the audit of accounts for the year ended 31st March, 2000, you as auditor find that:

(i) H, who is incharge of purchases has introduced fictitious purchase bills of Rs.50 lakhs.

(ii) W, who is incharge of sales has sold goods worth Rs.1 crore without bringing the same in the books of account.

You raise the matter with H and W in their capacity as directors. They contest that as this is a position known to them and within their own fold, you should not report the same under the Companies Act, 1956.

Discuss whether the above arguments are acceptable under the Companies Act, 1956 for non-reporting. If not, state the reasons and the manner of reporting. *(6 marks)*

(b) Under the Manufacturing and Other Companies (Auditor's Report) Order, 1988, an auditor is required to report on the regularity of payment of Provident Fund and Employees' State Insurance dues.

Give alternative drafts of the report on this clause mentioning the circumstances of reporting. *(6 marks) (Final Nov 2000)*

Answer

(a) The arguments put forth by H and W, directors of H.W.P. Pvt. Ltd., for non-reporting of fictitious purchases of Rs.50 lakhs and omission of recording of sales of Rs. 1 crore under the Companies Act, 1956 are not acceptable in view of the following reasons:

(i) The scope of audit of a company is determined by provisions of the Companies Act, 1956. Even the terms of the engagement cannot restrict the scope of audit in relation to matters which are prescribed by legislation. Corresponding to scope of audit, even the rights of an auditor available under statute cannot be restricted. In the case of *Newton v. Birmingham Small Arms Co. (1895)*, it was held that any regulation which precludes the auditors from availing themselves of all the information to which they are entitled under the Companies Act are inconsistent with the Act.

(ii) Section 227(2) provides that the duty of an auditor is to make a report to the members of the company. In his report, the auditor has to state whether "in his opinion and to the best of his information and according to the explanations given to him", the accounts "give a true and fair view in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year and in the case of the profit and loss account, of the profit or loss for its financial year". Thus, the primary duty of the auditor is to determine whether the balance sheet shows a true and fair view of the state of the company's affairs as at the end of the financial year and whether the profit and loss account shows a true and fair view of the working results of the company for the year.

(iii) The Companies Act, 1956 does not make any distinction between a private limited company and a public limited company. Therefore, the fact that there are only two members and they are fully aware of such transactions would not have any impact as far as scope of audit is concerned. The decision in *Pendleburys Ltd. vs. Ellis Green and Co. (1936)* holding the auditors not liable for not reporting separately to the shareholders as the report had been given to the directors who are the sole shareholders, will not hold good at present.

Therefore, in view of the above mentioned reasons, inflation of purchases (which in this case is of Rs.50 lakhs) and omission of sales (which in this case is of Rs.1 crore) is bound to affect the true and fair view of the financial statements of the company. It would, therefore, be obligatory on the part of auditor to report these aspects in the audit report.

The following paragraph in the audit report under section 227 of the Companies Act, 1956 should be included:

"The purchases of Rs………. as reflected in the profit and loss account are overstated by Rs.50 lakhs and sales of Rs………as reflected in the Profit and Loss Account are understated by Rs.1 crore. This has had the effect of understating the profits of the company by Rs.1.50 crores. On account of these discrepancies, the current liabilities are overstated by Rs.50 lakhs, the current assets are understated by Rs.1 crore and reserves are understated (before tax) by Rs.1.50 crores."

Subject to the above, in our opinion and to the best of our information, the accounts do not portray a true and fair view.

Notes:

(i) Having regard to materiality aspects, the auditor may qualify the audit report instead of an adverse report which would involve usage of words "subject to the above" as a prefix to qualification paragraph followed by the statement that the accounts show a true and fair view.

(ii) The action of H and W in inflating purchases and deflating sales may have effect on the stock positions reflected in the stock ledgers and on the physical inventory. If it be so, it may also be essential to include appropriate remarks in the report required to be issued under Manufacturing and Other Companies (Auditor's Report) Order, 1988.

(b) **CARO 2003** issued under section 227(4A) of the Companies Act, 1956, requires the auditor to report whether the company is regular in depositing Provident Fund or Employees' State Insurance (ESI) dues with the appropriate authority. The clause further requires the auditor to indicate the extent of arrears if the same have not been deposited regularly. The auditor has to report on the regularity of deposit of provident fund and Employees' State Insurance dues irrespective of the fact whether or not there are any arrears on the balance sheet date. This is because there may be situations where a company has deposited the relevant dues before the end of the year while it has been in default in the matter for a significant part of the year. Statement on CARO issued by the Institute states that, "while the auditor has to report upon the regularity of the deposit, he is not required to specify in detail each instance where there has been a delay or the extent of the delay. It should be sufficient if he indicates whether generally the deposits have been regular or otherwise". The following are examples of the wording which may be used:

"Provident Fund/Employees' State Insurance dues have generally been regularly deposited with the appropriate authorities in all cases during the year".

"Provident Fund/Employees' State Insurance dues have generally been regularly deposited with the appropriate authorities though there has been a slight delay in a few cases".

"Provident Fund/Employees' State Insurance dues have not generally been regularly deposited with the appropriate authorities though the delays in deposit have not been serious".

"Provident Fund/Employees' State Insurance dues have not been regularly deposited with the appropriate authorities and there have been serious delays in a large number of cases".

In case, where there are arrears, the following wording may be used:

"Provident Fund/Employees' State Insurance dues relating to the period …… and aggregating to Rs…….. which had fallen due for deposit with the appropriate authorities had not been so deposited as at …….. Out of these, Rs…….. have been deposited subsequently".

Question 3

Is the auditor of a company supposed to refer any paragraph in Director's report in his own report to the shareholders of the company? State your views in this regard.

(8 marks) (Final Nov 2000)

Answer

Section 217 of the Companies Act, 1956 specifies the contents to be included in the Board of Directors' report and states that there shall be attached to every balance sheet laid before a company in general meeting, a report by its Board of Directors, with respect to:

(i) the state of the company's affairs;

(ii) the amounts, if any, which it proposes to carry to any reserves in such balance sheet;

(iii) the amount, if any, which it recommends should be paid by way of dividend;

(iv) material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the financial year of the company to which the balance sheet relates and the date of the report;

(v) conservation of energy, technology absorption, foreign exchange earnings and outgo, in such manner as may be prescribed.

The Board's report shall also contain the material aspects relating to appreciation of the state of company's affairs and deal with important changes. The Board shall also be bound to give the fullest information and explanation in its report aforesaid, or in case falling under the proviso to Section 222, in an addendum to that report, on every reservation, qualification or adverse remark in the auditors' report.

Section 227 of the Act states that it is the duty of an auditor to make a report to the members of the company on the accounts examined by him on every balance sheet and profit and loss account, and every other document declared by this Act to be part of annexed to the balance sheet or profit or loss account which are laid before the company in general meeting during his tenure of office. Thus, as per section 227, the auditor is required to report only on those documents which are part of or annexed to the Balance Sheet and Profit and Loss Account. The subject matter of the auditor's report is the books of account and the financial statements including notes thereon and any other documents annexed thereto and not the Board's Report which as per section 217 is attached to balance sheet.

Section 222 of the Act dealing with construction of reference to documents annexed to accounts also makes it clear that Board's report is attached to the annual accounts. Therefore, normally the auditors' report does not cover authentication of various matters contained in the Board's report. This is despite the fact that the Board's report contains many matters as stated above, having a bearing on accounts and financial position of the company.

For example, the amount of proposed dividend, amount of depreciation, the net profit before tax and net profit after tax are common items that are contained in the Board's report.

However, proviso to section 222 requires that if any information which is required by this Act to be given in the accounts, and is allowed by it to be given in a statement annexed to the accounts, may be given in the Board's report instead of in the accounts; and if any such information is so given, the report shall be annexed to the accounts and this Act shall apply in relation thereto accordingly, except that the auditors shall report thereon only in so far as it gives the said information.

Question 4

On 30th September, 2000 a company's issued and paid up capital was Rs.25 crores comprising of fully paid equity shares of Rs.10 each. This included Rs.50,00,000 capital issued for cash; Rs.4,50,00,000 capital issued for purchase of a business; Rs.20 crores on issue of bonus shares from time to time by capitalising various reserves including Rs.5 crores by capitalising capital redemption reserve.

The company had fixed assets costing Rs.2 crores on which depreciation provision was Rs.1.95 crores, which was equal to the full cost of depreciable assets. The balance Rs.5 lakhs represented the cost of land. It has discontinued its operations for last many years.

The company had made investments in various companies to the tune of Rs.30 crores. Unfortunately all these investee companies have turned out to be BIFR cases. Nothing is expected to be realised on such investments. The company has dues from customers totalling to Rs.4.95 crores of which Rs.4.90 crores are due from business which have become defunct. The balance Rs.5 lakhs are due for over 3 years. The accumulated losses are Rs.10 crores. The amounts due to suppliers are Rs.3 crores and they are overdue. The balancing figure in the Balance Sheet refers to loan from Financial Institutions.

Workers who had put in long years of service have lodged claims for termination benefits of Rs.10 crores, which have been decreed in their favour. No accounting entry has been passed for the same since the decree on 1.1.1997. In the light of Statement on Auditing and Assurance Standard – SA 570, relating to Going Concern, you are asked to write appropriate paragraph of audit report.

Give reason for supporting your report. *(8 marks) (Final Nov 2000)*

Answer

SA 570 on "Going Concern" requires the auditor to consider the appropriateness of the going concern assumption underlying the preparation of the financial statements which may no longer be appropriate. The following indications *inter alia* have to be taken into consideration in determining the appropriateness of the going concern assumption:

(i) Financial indications such as negative net worth, adverse key financial ratios, substantial operating losses, inability to pay creditors on due dates, etc.

(ii) Operating indications such as labour difficulties, loss of major market, etc.

(iii) Other indications include pending legal proceedings which may affect the concern adversely, sickness of entity under statutory definition, etc.

Having regard to aforesaid indicators and as per the facts of the case, the company is not a going concern as on September 30, 2000 on account of following reasons:

(i) The company has discontinued its operations for last many years. Its productive fixed assets are fully depreciated. The only productive asset left is land worth of Rs.5 lakhs.

(ii) The claim of workers for termination benefits amounting to Rs.10 crores though decreed on January 1, 1997 has not been provided for in the books of account.

(iii) The amounts recoverable from customers totalling Rs.4.95 crores of which Rs.4.90 crores are due from businesses which are totally defunct are doubtful of recovery in its entirety. Even the balance amount is due for more than three years. Hence, the entire amount is doubtful of recovery.

(iv) The company has not been able to pay to its suppliers amounting to Rs.3 crores which are overdue.

(v) The company's investment to the tune of Rs.30 crores are not realisable and are worthless in view of the fact that all investor companies have turned sick.

(vi) The balance figure for term loan from financial institutions works out to be Rs.17 crores as per records even which the company is unable to pay.

Thus, in view of the aforesaid financial, operating and other indicators, the assumption of going concern is not appropriate.

Paragraph in the Audit Report: "The company as at September 30, 2000 has an accumulated loss of Rs.10 crores, has irrecoverable debts of Rs.4.95 crores as at that date, the diminution in value of its investments is of Rs.30 crores as at that date and a non-provision of decreed obligations in favour of employees of Rs.10 crores. The company has discontinued its operations for last many of years and has not been able to honour its obligation to creditors and financial institutions for quite some time. Thus, total accumulated losses are Rs.54.9 crores (and not as……… reported).

After taking into account the above factors we are of the opinion that the company is not a going concern as at September 30, 2000 and, thus, the usage of going concern assumption in the preparation of financial statements is inappropriate.

In our opinion, subject to the information given in preceding paragraph, the financial statements do not give a true and fair view of the financial position of the company at September 30, 2000 and the results of its operations for the year then ended".

Note: The Companies (Amendment) Act, 2000 also requires that the auditor's report shall also state in thick type or in italics the observation or comments of the auditors which have any adverse effect on the functioning of the company.

Question 5

As an auditor, state your view on the following:

The Statutory Auditors of a Government Company have issued a qualified Audit Report on the accounts of the company. In his supplementary audit, the Comptroller and Auditor General of India (C and AG) has also made further qualifications on the accounts of the company.

But the report of the Board of Directors of the Company is silent on the comments of statutory auditors and those of C and AG. (5 marks) (Final May 2002)

Answer

Board's Report and Qualifications in the Auditor's Report: Section 217(3) of the Companies Act, 1956 imposes a duty on the Board of directors of a company to give the fullest information and explanations in the Directors' report regarding every reservation, qualification or adverse remarks contained in the auditor's report. The remarks of the Board on the auditor's report are to be given as addendum to the report and are to form part of the main body of the report as per section 217(3). Hence there is failure on the part of the Board of directors in not having offered its explanation on the reservations, qualifications or adverse remarks made in the auditor's report.

However in the absence of similar provisions in section 217(3) of the Companies Act, 1956 requiring the company to give their reply on the reservations, qualifications etc. contained in the supplementary audit report made by the C&AG, the Board of Directors of such a company is not bound to give information or explanation in respect of such comments. Therefore, in the absence of any legal provision, the Board, has not committed any default by not giving any explanation on comment of the C&AG.

Question 6

Write short notes on the following:

(a) *Propriety elements in MAOCARO, 1988*

(b) *Audit Certificate as distinguished from Audit Report* *(Final May 2002)*

(c) *Disclosure under "Basis of Issue Price" in prospectus.* (4x3=12 marks)(Final May 2006)

Answer

(a) Propriety Elements in MAOCARO, 1988: Propriety audit stands for verification of transactions on the tests of public interest, commonly accepted customs and standards of conduct. Instead of too much dependence on documents, vouchers and evidence, it shifts the emphasis to the substance of transactions and looks into the appropriateness thereof on a consideration of financial prudence, public interest and prevention of wasteful expenditure. Normally speaking, the company audit under section 227 of the Companies Act, 1956 does not contain an element of propriety. However, with the passage to time, the legislature has incorporated several clauses which involve an element of propriety. MAOCARO, 1988 issued under Section 227(4A) of the Companies Act, 1956 contains following clauses involving propriety element:

(a) If the company has taken any loan, secured or unsecured, from other companies, or other parties listed in the registers maintained under sections 301 and 370 (1C) of the Companies Act, whether the rate of interest and the terms and conditions of such loans are prima facie prejudicial to the interests of the company. In this case, the auditor will have to look into the reasonableness of the rate of interest and the terms and conditions of such loans. In other words, he will have to see whether the terms and conditions, including the rates of interest are apparently adverse to the interests of the company, having regard to the circumstances of the company at the time of taking the loans and the terms normally available. He is to exercise his judgement based on commercial considerations like urgency, security offered, etc.

[Note: Students may note that the MAOCARO, 1988 has been superceded by the Companies (Auditor's Report), Order, 2003. The above answer is based on MAOCARO, 1988]

(b) If the company has granted any loans, secured or unsecured, to companies, firms or other parties listed in the register(s) maintained under section 301 and/or to the companies under the same management as defined under sub-section (1B) of Section 370 of the Companies Act, 1956 (1 of 1956), whether the rate of interest and other terms and conditions of such loans are prima facie prejudicial to the interests of the company

(c) Whether the transactions of purchase of goods and materials and sale of goods, materials and service, made in pursuance of contracts or arrangements entered in the register(s) maintained under section 301 of the Companies Act, 1956 (1 of 1956) aggregating during the year to Rs.50,000 (Rupees fifty thousand) or more in respect of each party, have been made at prices which are reasonable having regard to prevailing market prices for such goods, materials, or services or the prices at which transactions for similar goods or service have been made with other parties.

(d) Is the company regular in depositing Provident Fund and Employees' State Insurance dues with the appropriate authority and if not, the extent of arrears of Provident Fund an employees' State Insurance dues shall be indicated by the auditor. [Paragraph 4(A) (vii)].

(e) Whether personal expenses have been charged to revenue account; if so, the detail thereof should be reported.

(b) Audit Certificate as distinguished from Audit Report: A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. The term 'certificate' is, therefore, used where the auditor verifies the accuracy of facts. An auditor may thus, certify the circulation figures of a newspaper or the value of imports or exports of a company. An auditor's certificate represents that he has verified certain figures and is in a position to vouchsafe their accuracy as per his examination of documents and books of account. A report, on the other hand, is a formal statement usually made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill. The 'report' involves expression of opinion which may differ from one professional to another. There is no question of exactitude in case of a report since the information contained therein is based on estimates and involves judgement element.

(c) Disclosures under 'Basis of Issue Price': Under this heading, the following information is to be disclosed:

(i) (a) Earnings per share, i.e., EPS pre-issue for the last three years (as adjusted for changes in capital);

(b) P/E pre-issue and comparison thereof with industry P/E where available (giving the source from which industry P/E has been taken);

(c) Average return on net worth in the last three years;

(d) Minimum return on the increased net worth required to maintain pre-issue EPS;

(e) Net Asset Value per share based on last balance sheet;

(f) Net Asset Value per share after issue and comparison thereof with the issue price.

Provided that projective earnings shall not be used as a justification for the issue price in the offer document.

(ii) The accounting ratios disclosed in the offer document in support of basis of the issue price shall be calculated after giving effect to the consequent increase of capital on account of compulsory conversions outstanding, as well as on the assumption that the options outstanding, if any, to subscribe for additional capital will be exercised.

Question 7

Answer the following:

(a) Mention the difference between 'report' and 'certificate.' (4 marks)

(b) What are the contents of reports and certificates for special purposes? (6 marks)

(c) What are the reporting requirements for closing stocks in the Manufacturing and other Companies (Auditors Report) Order, 1988? (6 marks) (Final Nov 2002)

Answer

(a) Difference Between Report and Certificate: A certificate is written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. A report on the other hand, is a formal statement usually made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon. These words are fundamentally distinct from each other. Etymologically, the word 'certificate' is derived from Latin words *certus* (Certain) and *facere* (to make). So, the certificate connotes verification of certain and exact facts. However, the rendition of this type of statement is an impossible task and the auditor's duty indeed becomes onerous. The dictionary meaning of the word 'report' refers to formal account of results after an enquiry, examination or review given by an authorised person or group of reasons.

In other words, when a certificate is issued, the auditor is responsible for the factual accuracy of what is contained therein. However, when a report is given, the auditor is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts and that it is arrived at by the application of due care and skill.

(b) Contents of Reports and Certificates for Special Purposes: The contents of reports and certificates for special purposes in many cases are specified by statute and cannot be changed. However, in cases where no format has been specified, the reporting auditor can choose the form and contents. In such cases, where a reporting auditor is free to draft his report or certificate, he should consider the following:

(i) Specific elements, accounts or items covered by the report or certificate should be clearly identified and indicated.

(ii) The report or certificate should indicate the manner in which the audit was conducted, e.g., by the application of generally accepted auditing practices, or any other specific tests.

(iii) If the report or certificate is subject to any limitations in scope, such limitations should be clearly mentioned.

(iv) Assumptions on which the special purpose statement is based should be clearly indicated if they are fundamental to the appreciation of the statement.

(v) Reference to the information and explanations obtained should be included in the report or certificate. In certain cases apart from a general reference to information and explanations obtained, a reporting auditor may also find it necessary to refer in his report or certificate to specific information or explanations on which he has relied.

(vi) The title of the report or certificate should clearly indicate its nature, i.e., whether it is a report or a certificate. Similarly, the language should be unambiguous, i.e., it should clearly bring out whether the reporting auditor is expressing an opinion (as in the case of a report) or whether he is only confirming the accuracy of certain facts (as in the case of a certificate). For this, the choice of appropriate words and phrases is important.

(vii) If the special purpose statement is based on general purpose financial statements, the report or certificate should contain a reference to such statements. However, the report or certificate should not contain a reference to any other statement unless the same is attached therewith. It should be clearly indicated whether or not the statutory audit of the general purpose financial statements has been completed and also, whether such audit has been conducted by the reporting auditor or by another auditor. In case the general purpose financial statements have been audited by another auditor, the reporting auditor should specify the extent to which he has relied on them. He may communicate with the statutory auditor for securing his cooperation and in appropriate circumstances, discuss relevant matters with him, if possible.

(viii) Where a report requires the interpretation of a statute, the reporting auditor should clearly indicate the fact that he is merely expressing his opinion in the matter. He should take sufficient care to ensure that in respect of matters which are capable of more than one interpretation, his report is not misconstrued as representing a settled legal position.

(ix) An audit report or certificate should ordinarily be a self-contained document. It should not confine itself to a mere reference to another report or certificate issued by the reporting auditor but should include all relevant information contained in such report or certificate.

(x) The reporting auditor should clearly indicate in his report or certificate, the extent of responsibility which he assumes. Where the statement on which he is required to give his report or certificate, includes some information which has not been audited, he should clearly indicate in his report or certificate the particulars of such information.

In certain cases, the form and/or contents of the report or certificate, as prescribed by a statute or a notification, may not be appropriate or adequate. In such situations, the reporting auditor may consider modifying the report or certificate on the basis of the aforesaid parameters, to the extent applicable. In case this is not possible, he should clearly indicate the limitations in his report or certificate itself.

(c) Reporting Requirements for Closing Stocks Under MAOCARO, 1988: The auditor has to make four specific statements on verification and valuation of closing stocks under MAOCARO, 1988 issued under section 227(4A) of the Companies Act, 1956. The order requires the auditor to state "whether physical verification has been conducted by the management at reasonable intervals in respect of finished goods, stores, spare parts and raw materials". Secondly, the auditor has to state, "Are the procedures of physical verification of stocks followed by the management reasonable and adequate in relation to the size of the company and the nature of its business? If not, the inadequacies in such procedures should be reported". Further, "whether any material discrepancies have been noticed on such verification as compared to book records, and if so, whether the same have been properly, dealt with in the books of account". Finally, "whether the auditor is satisfied on the basis of his examination of stocks that such valuation is fair and proper in accordance with the normally accepted accounting principles. Is the basis of valuation of stocks same as in the preceding year? If there is any deviation in the basis of valuation, the effect of such deviation, if material, should be reported".

The comment on the reasonableness and adequacy of the stock verification procedures requires that the auditor should examine the methods and procedures of such verification and may if considered appropriate by him, be also present at the time of stock-taking. He should, in any case, examine the instructions given by the management to the stock-taking personnel (which should preferably be in writing). Where stocks are material and the auditor is placing reliance on the physical verification by the management, it may be appropriate for the auditor to attend stocktaking and perform test counts. He should ascertain whether the cut-off procedures are adequate. The original physical verification sheets should be reviewed and selected items traced into final inventories, which in turn should be compared with stock records and other evidence such as stock statements submitted to banks. The procedures for identifying damaged and obsolete items of inventory should be reviewed. While commenting on this clause, the auditor should point out the specific areas where the procedures are not reasonable or adequate.

The auditor should look carefully into all material discrepancies between the book stocks and physical and physical inventories to examine whether the same have been properly adjusted in the books of account.

The auditor has also state whether the valuation of stocks is fair and proper in accordance with the normally accepted accounting principles. To determine what constitute the normally accepted accounting principles regarding valuation of stock, one may refer to Accounting Standard 2. This standard provides that, in general, inventories should be valued at the lower of historical cost and net realisable value.

[Note: Students may note that the MAOCARO, 1988 has been superceded by the Companies (Auditor's Report), Order, 2003. The above answer is based on MAOCARO, 1988]

Question 8

What is your understanding of the term "true and fair view" in a statutory audit report of a company? (8 marks) (Final May 2003)

Answer

Meaning of Expression "True and Fair View": The requirements of the Companies Act, 1956 are that the auditor should specifically express an opinion whether the published accounts give a true and fair view of the company's state of affairs and of the profit and loss for the financial year. What constitutes a 'true and fair view' has not been defined in the Act. Sub-sections (1) and (2) of section 211 merely require that every balance sheet and profit and loss account of a company shall give a true and fair view of the state of affairs and profit or loss of the company and shall comply with the requirements of Schedule VI to the Companies Act, 1956 so far as they are applicable. Sub-section (5) of this section implies that the balance sheet and the profit and loss account of a company shall be deemed as not showing a true and fair view, if they do not disclose any matters which are required to be disclosed by virtue of the provisions of Schedule VI or by virtue of a notification or an order of the central government modifying the disclosure requirements. It is clear that the auditor will have to examine whether the financial statements are drawn up in conformity with the provisions of

Schedule VI and whether they contain the matters required to be disclosed therein. Thus, one of the tests for determining whether or not the financial statements show a true and fair view is to check whether all relevant disclosures as required be the governing Act have been properly made.

The phrase 'true and fair' in the auditor's report signifies that the auditor gives an opinion as to whether the financial statements represent fairly the actual financial position as at the end of the accounting period and profit or loss for that period. SA 200A, "Objective and Scope of the Audit of Financial Statements" states that, "in forming his opinion on the financial statements, the auditor follows procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The auditor recognises that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatement may remain undiscovered. While in many situations the discovery of a material misstatement by management may often arise during the conduct of the audit, such discovery is not the main objective of audit nor is the auditor's programme of work specifically designed for such discovery. The audit cannot, therefore, be relied upon to ensure the discovery of all frauds or errors but where the auditor has any indication that some fraud or error may have occurred which could result in material misstatement, the auditor should extend his procedures to confirm or dispel his suspicions." What constitutes a true and fair view is, thus, a matter of an auditor's judgement in the particular circumstances of a case. However, the following general guidelines may be laid down in this regard.

(a) The balance sheet and the profit and loss account should be drawn up in conformity with the requirements of the Companies Act or those of the specific Acts governing certain classes of companies.

(b) Relevant information should be so disclosed in the balance sheet and the profit and loss account that the financial position and the working results are shown as they are, i.e. there is neither an overstatement nor an understatement. There should be no window-dressing; the balance sheet and the profit and loss account should not attempt to show a better picture than what it is in reality. Similarly, there should be no secret reserves (unless the statute specifically permits the creation of such reserves).

(c) All material facts regarding expenses, revenues, assets and liabilities of the company should be disclosed. There should be no misstatement.

(d) All unusual, exceptional, or non-recurring items should be disclosed separately.

(e) The balance sheet and the profit and loss account should be prepared and presented in conformity with the generally accepted principles of accounting. Such principles should be consistently applied. The effect of a change in these principles should be suitably disclosed.

(f) The auditor should examine the situation as it exists at the end of the accounting period. If certain subsequent events help the auditor in making a better assessment of the position as at the date of the balance sheet, the auditor should take such events into account.

(g) The financial statements should convey the required information clearly. As has been held in many legal cases, information and means of information are by no means equivalent terms. A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much of information as is calculated to induce them, or some of them, to ask for more.

Question 9

Distinguish with suitable examples - Between a case where an auditor is obliged to state in his report to the members of a company that the accounts do not show a true and fair view, and a case where he states that he is unable to form an opinion as to whether or not the accounts give a true and fair view. *(8 mark) (Final Nov 2003)*

Answer

Adverse Report and Disclaimer of Opinion: SA 200 " Basic Principles Governing an Audit" states that the audit report should contain a clear written expression of opinion on the financial information. In order to express such an opinion, the auditor should review and assess the conclusions drawn from the audit evidence obtained by him. This review and assessment involves forming an overall conclusion as to whether:

(a) the financial information has been prepared using acceptable accounting policies, which have been consistently applied;

(b) the financial information complies with relevant regulations and statutory requirements;

(c) the view presented by the financial information as a whole is consistent with the auditor's knowledge of business environment; and

(d) there is adequate disclosure of all matters relevant to the proper presentation of financial information.

The opinion expressed by an auditor may be unqualified, adverse, qualified or a disclaimer of opinion depending upon the degree of satisfaction of the auditor about the overall truth and fairness of the financial statements.

An adverse opinion should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements. Such an opinion is issued when the effect of disagreement is so material and pervasive to financial statements that the auditor concludes that a qualification of his report is not adequate to disclose the misleading or incomplete picture of the financial statements. This conclusion can be reached by the auditor in an extreme case where there had been flagrant violation of the accounting principles or evidence is not available for material transactions or within the knowledge of the auditor there exists material concealment or misstatement about financial affairs. He must have strong and convincing evidence in favour of his conclusion. It should be appreciated that this opinion is also an overall opinion and owes direct relationship to the portrayal of the financial position in the accounting statements. If one or two illegal transactions of not much significance have taken place and they have been fairly presented and disclosed in the accounting statements, it can not be held that the accounting statements are not true and fair. They are true and fair subject to the illegality already disclosed. The audit report stating that the accounts do not show a true and fair view is indeed an extreme and rare case. In case an auditor has to report to that effect, there must exist reservations on the accounts affecting materially the accounts taken as a whole. The reservation should not be such that it only partially affects the accounts. Also, mere reservation in the mind of the auditor is not enough, he must have convincing and definite evidence to state that the accounts are so materially irregular that they do not show a true and fair view.

SA 700, "The Auditor's Report on Financial Statements" requires that a disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and is, accordingly, unable to express an opinion on the financial statements. A limitation may be imposed by circumstances, for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories. It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion. This would also be the case when internal control is so weak as to prevent the auditor from putting any reliance on the accounts. Therefore, to be fair and just, he should state that he is unable to form an opinion as to whether or not accounts give a true and fair view, for example, when the auditor was not able to examine a substantial part of the books of accounts because they were in police custody. In both the situations, the auditor should give also his reasons for the report he makes. Instances in which the auditor faces limitations on the scope of his work, it is appropriate for him to state that he has not been able to form an opinion.

Question 10

Write a short note on - Reporting on the compilation engagement. (4 marks) (Final Nov 2003)

Answer

Reporting on the Compilation Engagement: The objective of a compilation engagement is to use accounting expertise, as opposed to auditing expertise, to collect, classify and summarise financial information, This ordinarily entails reducing detailed data to a manageable and understandable form without the requirement to test the assertions underlying that information. The procedures employed are not designed and do not enable the member to express any opinion on the financial information. Therefore, it is essential that the member clearly brings out the nature of association with the financial statement and the nature of the work performed by him. The following may be noted in this regard.

i. The title of the report should be "Accountant's Report on Unaudited Financial Statement and not An Auditor's Report".

ii. The report should be addressed to the appointing authority.

iii. The report should identify the financial information compiled, also stating that it is based on the information provided by the management.

iv. The report should clearly state that the financial statements are not audited.

v. In describing the engagement, ambiguous terms such as review, general review, check, etc. should not be based.

vi Date of the report should be mentioned.

vii Name and address of the firm of the member appointed for carrying out the compilation engagement should be mentioned.

viii Signature and the designation (sole proprietor/ partner) and membership number should appear in the report.

Question 11

As Chartered Accountant you are required to give your reports on various financial statements under Companies Act, 1956 which are as under:

(i) Report to the shareholders under Section 227;

(ii) Report to be set out in prospectus under Section 60(3);

(iii) Report to be given to the Central Government as special auditor under Section 233A;

(iv) Report to be given on voluntary winding up under Section 488(1).

Explain the significance of each of these reports and your functional approach very briefly.

(8 marks) (Final May 2004)

Answer

Auditor's report on the Companies Act, 1956 (the Act)

(i) Report to Shareholders U/s 227: Section 227 of the Act lays down powers and duties of the auditor. Sub-sections (2), (3), (4) and (4A) of Section 227 deal with reporting requirements. Sub-section (2) states that the auditor of a company shall make a report to the members on the accounts examined by him and on every balance sheet and profit and loss account which are laid before company in general meeting during the tenure of his office. The significance of the report lies in the fact that it requires that the report shall state whether in his opinion and to the best of his information and according to the explanations given to him the said accounts give the information required by the Act in the manner so required and give a true and fair view.

The functional approach by the auditor for making a report u/s 227 of the Act, requires him to perform compliance and substantive audit procedures to verify the information contained in the financial statements. Having regard to the materiality of the items involved, the auditor also determines whether the relevant information is properly disclosed in the financial statements.

(ii) Report to be set out in the prospectus u/s 60(3): Section 60(3) of the Act provides that a prospectus should be accompanied *inter alia* by the consent in writing of the person named therein as the auditor of the company or intended company, to act in that capacity. Part II of Schedule II to the Act prescribes the reports to be set out in a prospectus. The report contains particulars about profit and losses of the company for five preceding year, assets and liabilities, rates of dividend, etc. The significance of the report lies in the fact that a prospectus is issued by a company when it seeks to raise funds from the public and gives detailed information about the company to enable prospective investors to take a well-informed decision. The functional approach on the part of auditor involves obtaining information from the management, particularly, in respect of estimation of current and future profits. He has to also ensure that all adjustments have been made properly.

(iii) Special Audit Report U/s 233A: Under section 233A of the Act, the Central Government has a power to order a special audit of the accounts of a company for a specified period. An order to conduct special audit of the accounts of a company may be made where the Central Government is of the opinion that:

(a) the affairs of the company are not being managed in accordance with sound business principles or prudent commercial practices; or

(b) the company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or

(c) the financial position of the company is such as to endanger its solvency.

The main objective of such an audit is to provide a critical review of the company's working and state of affairs to the government. Special audit should be distinguished from 'investigation' into the affairs of a company under section 235 of the Act. The special auditor has the same powers and duties which a company auditor has under section 227 of the Act, with the difference, however, the instead of making his report to the members of the company, the special auditor makes the report to the central government. The special audit report should, as far as possible, include all the information required to be included in an audit report under section 227 of the Act. However, the central government may direct that the special audit report shall also include a statement on any other matter referred to the special auditor by the government.

(iv) Report on the accounts prepared on voluntarily winding up u/s 488 (1): Section 488(1) of the Act requires that where it is proposed to wind up a company voluntarily, its directors, or in case the company has more than two directors, the majority of the directors, may at a meeting of the Board, make a declaration verified by an affidavit, to the effect that they have made a full inquiry into the affairs of the company, and that, having done so, they have formed the opinion that the company has no debts, or that it will be able to pay its debts in full within such period not exceeding three years from the commencement of the winding up as may be specified in the declaration. Such declaration has to be accompanied by a copy of the report of the auditors of the company (prepared, as far as circumstances admit, in accordance with the provisions of this Act) on the profit and loss account of the company for the period commencing from the date up to which the last such account was prepared and ending with the latest practicable date immediately before the making of the declaration and the balance sheet of the company made out as on the last mentioned date and also embodies a statement of the company's assets and liabilities as at the date.

Question 12

Bring out the significance of the following two illustrative paragraphs found in the statutory auditor's report in recent days.

(i) Opening Paragraph:

"We have audited the attached Balance Sheet of …….. as at 31st March, 2xxx and also the Profit and Loss Account for the year ended on that date annexed thereto. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements". (4 marks)

(ii) Scope Paragraph:

"We conducted our audit in accordance with the auditing standards generally accepted in India. Those standards require that we plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material statement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial presentation. We believe that our audit provides a reasonable basis for our opinion." (4 marks) (Final Nov 2004)

Answer

(i) Opening Paragraph: The opening or introductory paragraph identifies the financial statements of the entity that have been audited, including the date of and period covered by the financial statements. Further, the significance of 'opening paragraph' is to bring to the notice of the users of financial statements that preparation of the accounts is the responsibility of the management of the enterprise, whereas the responsibility of the auditor is to express an opinion on the said accounts based on audit carried out by him. The preparation of such statements requires management to make significant accounting estimates and judgements, as well as to determine the appropriate accounting principles and methods used in preparation of the said statements.

(ii) Scope Paragraph: The significance of 'scope paragraph' is to inform the users about the practices and procedures followed in conduct of audit by the auditor. The auditor states in this paragraph that the audit was planned and performed in accordance with generally auditing standards generally accepted in India. The auditor also states that the audit provides a reasonable basis for his opinion. The significance of this paragraph lies in the fact that auditor wishes to convey to readers about the scope of audit by highlighting the nature and process of audit. The test check approach of audit adopted by the auditor in performing his work as also the significant aspect of evaluation of accounting principles and accounting estimates is also clarified. The basic objective of auditing that the auditor provides only "reasonable assurance" is emphasised in this paragraph. In a way, such a statement signifies inherent limitations of audit.

Question 13

Write a short note on - Certificate for Special Purpose vs. Audit Report. .

(4 marks) (Final Nov 2004)

Answer

Certificate for Special Purpose vs. Audit Report: A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. Government authorities may under various statutes or notifications, require reports or certificates from auditors in support of statements or other information prepared by an enterprise. Reports or certificates on specific matters may also be required from auditors by an enterprise, for its own special purposes. These reports or certificates to specific requirements of the individual users is unlike a 'general purposes report' e.g. an auditor's report on financial statements which is intended for general use. A report, on the other hand, is a formal statement usually made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein, e.g., certification of export turnover, etc. On the other hand, when the reporting auditor gives the report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill.

Question 14

(a) *A Pvt. Ltd. is incorporated on 1st July, 2004. During the year ended 31st March, 2005, it had issued shares (fully paid up) of Rs. 40 lakhs, had borrowed Rs. 7.5 lakhs each from 2 financial institutions and its turnover (Net of excise Rs. 50 lakhs which is credited to a separate account) is Rs.475 lakhs. Will Companies Auditors Report Order, 2003 (CARO) be applicable to A Pvt. Ltd.?* *(4 marks)*

(b) *As the statutory auditor of B Ltd. to whom CARO, 2003 is applicable, how would you report in the following situations?*

(i) *The company has stood guarantee to its sister concern, whose financial condition was not healthy for a sum of Rs. 20 lakhs borrowed from a bank.*

(ii) *Physical verification of only 50% (in value) of items of inventory has been conducted by the company. The balance 50% will be conducted in next year due to lack of time and resources.*

(iii) *Accumulated losses of the company are 50.9% of its net worth and it is incurring continuous cash losses since last 2 years.* *(4×3 = 12 marks) (Final May 2005)*

Answer

(a) The Companies (Auditor's Report) Order (CARO), 2003, exempts private limited companies from its application which fulfils all the following conditions:

(i) the paid up capital and reserves are Rs.50 lakhs or less;

(ii) it has not accepted any public deposits;

(iii) it has no outstanding loan of Rs.10 lakhs or more from any bank or financial institution; and

(iv) its turnover does not exceed Rs.5 crores.

In the case of M/s A Pvt. Ltd., its paid-up capital is less than Rs.50 lakhs, turnover is less than Rs. 5 crores since excise duty is not taken into account if it is credited separately to excise duty account; and, it is also implied from the facts that it has not accepted any public deposits. However, it fails to fulfil condition relating to outstanding loan because as per the statement on CARO, 2003, issued by the Institute requires that the amount of outstanding loan taken from bank/financial institution have to be considered on a cumulative basis. M/s A Pvt. Ltd. has total borrowings of Rs. 15 lakhs and thus fails to satisfy all conditions and accordingly CARO, 2003 will be applicable.

(b) (i) Para 4(xv) of CARO, 2003 requires the auditor to state in his report whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and condition whereof are prejudicial to the interests of the company. The auditor should examine the Memorandum of Association to determine whether the company has the power to give guarantee. The auditor should also examine the minute book and register of guarantee to ascertain whether guarantee has been issued under the sanction of competent authority. The auditor should also verify compliance with requirements of sections 295 and 372A of the Companies Act, 1956. It should also be ensured that the guarantee given is shown as contingent liability.

In determining whether the guarantee is prejudicial to the interest of the company, the auditor should consider financial standing of the party, nature of security offered, etc. In this case, since financial condition of the company on behalf of whom guarantee is given is not so good, the auditor may consider expressing an opinion that the terms and conditions on which the company has given guarantees for loans taken by the sister concern, i.e., M/s B Ltd., is prejudicial to the interests of the company.

(ii) Para 4(ii)(a) of CARO, 2003 requires the auditor to state in his report whether physical verification of inventory has been conducted at reasonable interval by the management. Physical verification of inventory is the responsibility of the management which should verify all material items at least once in a year and more often in appropriate cases. The auditor in order to satisfy himself about verification at reasonable intervals should examine the adequacy of evidence and record of verification. In the given case, the above requirement of CARO, 2003 has not been fulfilled as such and the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable. He may consider the impact on financial statement and report accordingly.

(iii) Para 4(x) of CARO, 2003 requires the auditor to state in his report in respect of a company which is in existence for more than 5 years from the date of registration:

(a) whether the accumulated losses at the end of the year are more than 50% of its net worth; and

(b) whether it has incurred cash losses during the current year and the immediately preceding financial year.

In the instant case, since the company is covered by the above requirements, there are symptoms of potential sickness and, thus, auditor should report the same. It is, however, to be assumed that the company is in existence for more than 5 years.

(Note: Students may note that the CARO, 2003 has been amended by the Companies (Auditor's Report) (Amendment) Order, 2004 which is effective for all audit reports issued on or after November 25, 2004. While answering this question, the position as contained in the original CARO, 2003 has been considered.)

Question 15

Answer the following:

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

(b) Illustrate, as a statutory auditor, how would you give a report where all qualifications are not quantifiable. (4 marks)

(c) Under CARO, 2003 how, as a statutory auditor would you comment on the following:

(i) Fixed assets comprising 1/3rd of the total assets have been disposed off during the year. (4 marks)

(ii) A Term Loan was obtained from a bank for Rs.75 lakhs for acquiring R&D equipment, out of which Rs.12 lakhs was used to buy a car for use of the concerned director, who was overlooking the R&D activities. (4 marks)(Final Nov 2005)

Answer

(a) Statements of facts u/s 227 of the Companies Act, 1956: Section 227 of the Companies Act, 1956, deals with contents of the audit report. Some of these aspects on which the auditor is required to report which constitute statements of fact are as under:

(i) Whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit.

(ii) Whether the report on the accounts of any branch office audited u/s 228 has been forwarded to him and how has he dealt with the same in preparing the auditor's report.

(iii) Whether the company's balance sheet and profit and loss account dealt with by his report are in agreement with the books of account.

(iv) Whether any director is disqualified from being appointed u/s 274(1)(g) of the Companies Act, 1956.

(v) Whether cess payable u/s 441A has been paid and if not, the details of amount not paid. (This clause has not yet became operative).

(b) An illustrative Format of Audit Report: SA 700 "The Auditor's Report on Financial Statements", states that there may be circumstances when it is not practicable to quantify the effect of modification in the audit report accurately, the auditor may do so on the basis of estimates made by the management after carrying out such audit tests as are possible and clearly indicate the fact that the figures are based on management estimates. Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

The following illustration of a qualification where quantification was not possible will explain the point:

"(2) No provision has been made in respect of product warranties outstanding at the year end. The amount of provision required in this behalf could not be ascertained."

In the above situation, the overall paragraph would appear as follows:

"We further report that, without considering item mentioned in paragraph (2) above, the effect of which could not be determined, had the observations made by us in paragraph (1) (not reproduced) and (2) above been considered, the profit for the year would have been Rs.500.41 lacs (as against the reported figure of Rs.596.07 lacs), reserves and surplus would have been Rs.685.43 lacs (as against the reported figure of Rs.781.09 lacs) and total fixed assets would have been Rs.200.00 lacs (as against the reported figure of Rs.229.05 lacs)"

Subject to the above in our opinion……………….

(c) (i) Disposal of Fixed Assets: Under CARO, 2003, an auditor is required to state if substantial part of the fixed assets have been disposed off during the year, whether it has affected the going concern. This clause requires the auditor to carry out adequate audit procedures to satisfy himself that the company shall be able to continue as going concern for the foreseeable future despite the sale of substantial part of the fixed assets.

Accordingly, in the instant case, the auditor should satisfy himself as to whether disposal off of $1/3^{rd}$ of fixed assets during the year had any effect on the going concern assumption on account of such sale of fixed assets. The auditor is required to exercise his professional judgement to determine whether disposal off of one-third of total assets constitutes substantial part or not. Depending upon the judgement arrived at by the auditor, he shall report whether substantial part of fixed assets have been disposed off or not during the year and it has affected or not affected the going concern status of the company. Alternatively, in case the auditor is of the opinion that it constitutes substantial sale but the going concern assumption is appropriate because of mitigating factors then he has to ensure that the same are disclosed in the financial statements or else he shall have to modify the auditor report. The manner of reporting shall also be modified appropriately in case the going concern assumption is resolved or not.

(ii) **Utilisation of Term Loans:** Under CARO, 2003, an auditor is required to comment whether term loans were applied for the purpose for which the loans were obtained.

The auditor should examine the terms and conditions of the term loan with the actual utilisation of the loans. If the auditor finds that the fund has not been utilized for the purpose for which they were obtained, the report should state the fact.

In the instant case, since term loan taken for the purpose of R&D equipment has been utilized for purchase of car which has no relation with R&D equipment. Therefore, car though used for R&D Director cannot be considered as R&D equipment. The auditor should state the fact in his report that the out of term loan of R&D lack, Rs.12 lakhs was not utilised for the purpose of acquiring the R & D equipment.

Question 16

Answer the following:

(a) Discuss the various aspects to be considered by the Statutory Auditor before qualifying his report. (4 marks)

(b) As a Statutory Auditor, how would you report on the following under CARO:

(i) O Pvt. Ltd. Is a dealer in Shares and Securities.

(ii) ABC Pvt. Ltd. Is an Manufacturer of jewellery. A senior employee of the Company informed you that the Company does not properly disclose the purity of gold used on the jewellery. (4 marks)(Final May 2006)

Answer

(a) Aspects to be Considered Before Qualifying the Audit Report: SA 700, "The Auditor's Report on Financial Statements", specifies that auditor's report may need modification on account of certain matters which may or may not affect the auditor's opinion. There may be certain circumstances when an auditor may not be able to express an unqualified opinion because the effort of such circumstances in the auditor's judgment, is or may be material to the financial statements:

(i) there is a limitation on the scope of the auditor's work; or

(ii) there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

Further, while qualifying a report, it is important to appreciate as to which of the various items of statement of fact or statement of opinion require a qualification in respect of audits under the Companies Act, 1956, the auditor may also see whether the matters constituting the qualification involve a material contravention of any requirements of the Companies Act, 1956 which have a bearing on the accounts.

Finally, whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s), individually and in aggregate, on the financial statements should be mentioned in the auditor's report. A quantified opinion should be expressed as being "subject to" or "except for" the effects of the matter to which qualification related.

(b) Reporting under CARO, 2003

(i) O Pvt. Ltd. is a dealer in shares and securities. Clause (xiv) of CARO, 2003 is applicable to a company in case it is dealing or trading in shares, securities, debentures and other investments. The requirements applicable to O Pvt. Ltd. would be as under:

- whether proper records are maintained for transactions and contracts;
- whether timely entries are made in such records; and
- whether shares, securities, debentures and other investments have been held by the company in its own name except to the extent of exemption, if any granted under section 49 of the Companies Act, 1956.

In case auditor is satisfied in respect of aforesaid matters, after making examination, the auditor may report as under:

> "In our opinion, and according to information and explanation given to us, the company has been maintained proper records in respect of transactions and contracts in securities during the year and timely entries have been made therein. Further, all shares and certificates are held by the company in its own name."

(ii) In the case of ABC Pvt. Ltd. If purity of gold is not properly disclosed on the jewellery it amounts to defrauding the customers. That means the management is deceiving customers to obtain an illegal advantage. However, the auditor is concerned with fraudulent acts that cause a material misstatement in financial statements. As long as books of account are not falsified arising out of difference in the purity of gold, i.e., actual cost of the gold and the sale price of gold, it has no implication for the auditor. Further, under CARO, 2003, the auditor may examine this from the view point of maintaining proper records of inventory. But even the requirement of maintaining proper records does not necessitate that purity as such should be mentioned on the gold itself. However, the purity of gold would have implication on the valuation of inventory. But this aspect is not required to be reported under CARO, 2003.

Thus, from the view point of reporting on frauds under CARO, 2003, there is no implication for misstatement in the financial statements. Hence, no reporting is necessary for non-proper disclosure of purity of gold on the jewelry.

Question 17

Draft audit report u/s 227(3)(f) of the Companies Act, 1956 on the following three situations in respect XYZ Ltd. as on 31.3.2006:

(i) Where all directors have given written representations that they have not defaulted u/s 274(1)(g) of the Companies Act, 1956. (2 marks)

(ii) Where one of the directors, Mr. Flexible has failed to produce written representation that he has not defaulted u/s 274(1)(g) of the Companies Act, 1956. (3 marks)

(iii) Where on the basis of written representations received from the directors it is noticed that one of the directors, Mr. Rigid has defaulted in terms of Section 274(1)(g) of the Companies Act, 1956. (3 marks)(Final Nov 2006)

Answer

Draft audit report u/s 227 (3) (f):

(i) Where the directors have not defaulted :

"On the basis of the written representations received from the directors and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31 March, 2006 from being appointed as a directors in terms of Section 274(1)(g) of the Companies Act, 1956

(ii) Where one of the directors failed to produce written representation.

"Mr. Flexible who is also a director of XYZ Ltd. has not produced any written representation to the company as to whether XYZ Ltd. as at 31.03.06 had not defaulted in terms of Section 274(1)(g) of the Companies Act. In the absence of the representation we are unable to comment whether Mr. Flexible is disqualified from being appointed as director in terms of section 274(1)(g). As far as other directors are concerned on the basis of the written representation received from such directors and taken on record by the Board, we report that none of the remaining directors is disqualified as on 31.3.2006 from being appointed as a director in terms of Section 274(1) (g) of the Companies Act, 1956".

(iii) Where a director is found to be disqualified

"On the basis of the written representation received from Mr. Rigid who is a director of XYZ Ltd. as on 31.3.2006 and taken on record by the board, we report that Mr. Rigid is disqualified from being appointed as a director in terms of Section 274(1) (g) of the Companies Act, 1956. As far as other directors are concerned, on the basis of written representations received and taken on record by the board we report that none of the remaining directors is disqualified as on 31.3.2006 from being appointed as director in terms of Section 274 (1) (g) of the Companies Act."

Question 18

Explain the propriety elements in the Companies (Auditors) Report Order, 2003.

(8 marks)(Final Nov 2006)

Answer

Propriety elements in CARO 2003

(i) If a company has given or taken loans, secured or unsecured to/ from companies, Firms or other parties listed in the register maintained u/s 301 of the Companies Act, whether the rate of Interest and other terms and conditions of such Loans are prima facie prejudicial to the interest of the company.

(ii) If overdue amount of loan given to or taken from companies, firms or other parties listed in the register maintained u/s 301 of the Companies Act is more than one Lakh, what reasonable steps have been taken by the company for recovery/ payment of the principal and interest.

(iii) Whether the particulars of contracts or arrangements referred to in section 301 of the Act have been entered in the register required to be maintained. To ensure the transactions entered in the register maintained u/s 301 have been made at prices which are reasonable at the relevant time.

(iv) Whether the company is regular in depositing undisputed statutory dues including PF, income tax, sales tax, customs, excise duties and other statutory dues and if not , the arrears outstanding for more than 6 months from the date they became payable shall be indicated.

(v) Whether the company has made any preferential allotment of shares to parties covered in the register maintained u/s 301 and if so, whether the price at which they were issued is prejudicial to the interests of the company.

Question 19

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

(a) L Private Ltd., which has outstanding loan of Rs. 50 lakhs from Financial Institution defaulted in repayment thereof to the extent of 50%. The company holds that it being a private limited company, the Companies Auditors Report Order (CARO) is not applicable.

(5 marks)

(b) ABC Limited to whom CARO is applicable made a public issue of 7% debentures of Rs. 3 crores, redeemable after 5 years and used the proceeds of issue for payment of Sundry creditors and other Current liabilities to the tune of 3 crores. (4 marks) (Final May 2007)

Answer

(a) Applicability of CARO to a Private Ltd. Co.: A Private Ltd. Co., in order to be exempt from the applicability of CARO must satisfy all the following conditions cumulatively :

(i) its paid-up capital and reserves are Rs. 50 lacs or less;

(ii) it has no outstanding loan exceeding Rs. 25 lacs from any bank or financial institutions; and

(iii) its turnover does not exceed Rs. 5 crores during the financial year.

Since condition (ii), above, is violated, the order is applicable to L Pvt. Ltd.

The period and amount of default be reported by the auditor as per Para 4(xi) of the CARO.

(b) End use of issue proceeds of a public issue: Para 4(xx) of CARO deals with end use of issue proceeds of a public issue. Public issue may relate to equity shares, preference shares, debentures and other securities. The auditor is expected to verify and report whether the end use of moneys raised by way of public issue have been properly disclosed in the financial statements.

The auditor must see whether the terms of issue of debentures contain any specific purpose/project for which the funds raised will be utilized.

It the terms of issue of debentures is for liquidating sundry creditors and other current liabilities, it would be in order for the company to do so. Auditor should verify that the amount of end use of money disclosed in the financial statements by the management is adequate and is not significantly different from the proposed and actual use. If either end use is not for the purpose for which a public issue is made or the disclosure is not adequate, the auditor should state the fact in his report.

Question 20

What are the features of a qualified Audit Report? *(8 marks) (Final Nov 2007))*

Answer

The features of a qualified report are

1 ***Clarity**:* The auditor must express the nature of qualification, in a clear and unambiguous manner.

2 ***Explanation**:* Where the auditor answers any of the statutory affirmations in the negative or with a qualification his report shall state the reasons for such answer.

3 ***Placement**:* All qualifications should be contained in the Auditor's Report. When there are notes which are subject matter of a qualification, the same should preferably be annexed to the Auditors' Report. However a reference to the notes to Accounts in the Auditors' Report does not automatically become a qualification.

4. ***Subject to**:* The words' subject to are essential to state any qualification. The qualification should be preceded by words such as 'subject to' or except that' to make it clear that he is making an exception.

5. ***Quantification**:* It is also necessary that the auditor should quantify, wherever possible, the effect of individual as well as the total effect of all qualifications on profit or loss and/or state of affairs these qualifications on the financial statements in a clear and unambiguous manner. In circumstances where it is not possible to quantify the effect of

the qualifications accurately the auditor may do so on the estimates made by the management after carrying out such audit tests as are possible and clearly indicate that the figures given are based on the estimates of the management.

6. ***Nature of qualification**:* Vague statements the effect of which on accounts cannot be ascertained like 'the debtors balances are subject to confirmation', 'no provision for taxation has been made in view of the loss during the year' etc., should be avoided.

7. ***Violation of law**:* Where the company has committed an irregularity resulting in a breach of law, the auditor should bring the same to the notice of the shareholders by properly qualifying his report.

8. **Notes** – Report Relationship – Where notes of a qualificatory nature appear in the accounts the auditors should state all qualifications independently in their report so that the user can assess the significance of these qualifications.

9. ***Draft Report**:* The auditor may discuss matters of qualification with the management of the company to acquire their views. It is not necessary that the auditor should accept the managements view and modify his opinion. But it would enable the auditor to accurately draft the qualifications in his final report.

Question 21

List the matters to be included in the 'Auditors' report' in the case of Non Banking Financial Companies (NBFCs) accepting or holding public deposits. (8 marks) (Final Nov 2007)

Answer

The auditors are required to make a separate report to the Board of Directors and the RBI for every financial year as per the Non Banking Companies Auditors' Report (RBI) Direction 1998, in addition to the reporting obligations u/s 227 of the Companies Act 1956.

(1) *Reporting Requirements:* The auditor shall make –a statement on the following matters, together with reasons in case of any unfavourable or qualified statement:

  (a) *Registration:* Whether the NBFC has obtained certificate of Registration or applied for registration.

  (b) *Communication from RBI:* Whether the NBFC has received any communication from RBI refusing grant of Certificate of Registration.

(2) **NBFCs accepting/holding public deposits**

  (i) ***Limit on Public Deposits**:* Whether the public deposits and the following borrowings are within the permissible limits

    (a) Borrowing from public by issue of unsecured non-convertible Debentures/Bonds.

    (b) Borrowing from its share holders by a public limited company and

    (c) Other deposits within the definition of "Public Deposit" in the NBFC (Reserve Bank) Direction, 1998.

(ii) ***Credit Rating**:* Whether Credit rating for fixed Deposits, assigned by the credit rating agency is in force.

(iii) ***Limit on Fixed Deposits**:* Whether aggregate amount of Deposit outstanding at any point during the year has exceeded the limit specified by the Credit Rating Agency.

(iv) ***Default:*** Whether the NBFC has defaulted in paying to its Depositors the interest and/or principal amount of the deposits after such interest and/or principal became due.

(v) ***Prudential Norms**:* Whether the NBFC has complied with NBFC Prudential Norms (Reserve Bank) Direction, 1998 in relation to Income Recognition. According standards, classification, Provisioning for bad and doubtful debts and concentration of Credit/Investment.

(vi) ***Capital Adequacy**:* Whether the capital Adequacy Ratio disclosed in the return submitted to the RBI is correctly determined and whether such ratio is in compliance with the minimum capital to Risk Asset Ratio prescribed by the RBI.

(vii) ***Liquidity**:* Whether the NBFC has complied with the prescribed liquidity requirement and kept the approved securities with designated Bank.

(viii) ***Return of Deposits**:* Whether the NBFC has furnished the return of deposits to the RBI within the stipulated period as required under First Schedule to NBFC Prudential Norms (Reserve Bank) Directions, 1998.

Question 22

T Pvt. Ltd.'s paid up Capital & Reserves are less than Rs. 50 lakhs and it has no outstanding loan exceeding Rs. 25 lakhs from any bank or financial institution. Its sales are Rs. 6 crores before deducting Trade discount Rs. 10 lakhs and Sales returns Rs.95 lakhs. The services rendered by the company amounted to Rs. 10 lakhs. The company contends that reporting under Companies Auditor's Reports Order (CARO) is not applicable. Discuss.

(4 marks) (Final Nov 2007)

Answer

Since paid up capital and reserves of T Pvt. Ltd. is less than Rs. 50 lakhs and has no loan outstanding exceeding rupees 25 lakhs from any bank or financial institution, the only other condition is whether turnover exceeds rupees five crores. Turnover is not defined in the CARO. Part II of Schedule VI defines the term "turnover" as the aggregate amount for which sales are affected by the company. "Sales affected" would include sale of goods as well as services rendered by the company.

For ascertaining turnover though trade discount and sales returns should be deducted, the inclusion of services rendered would result in a turnover of Rs. 5.05 crores (i.e. 6 - 0.10 - 0.95 + 0.10 crore) Hence CARO will apply to T. Pvt. Ltd.

Question 23

Write a short note on- Emphasis of matter paragraph in Audit Reports.

(4 marks) (Final May 2008)

Answer

Emphasis of matter paragraph in audit reports: An auditor's report can be modified for matters that do not affect the auditor's opinion. An "emphasis of matter" paragraph is such a type of notification in an audit report. In certain circumstances, such a paragraph is added to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such a paragraph does not affect the auditor's opinion. Such a paragraph is preferably included preceding the opinion paragraph and would ordinarily refer to fact that the auditor's opinion is not quantified in this respect. (Refer SA 700).

An illustration of an emphasis of matter paragraph for a significant uncertainty in an auditor report is as follows :

"Without qualifying our opinion, we draw attention to note X of schedule to the financial statements. The entity is the defendant in a lawsuit alleging infringement of certain patent right and claiming royalties and punitive damages. The entity has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate of the matter can not presently be determined, and no provision for any liability, that may result, has been made in the financial statements."

Question 24

Discuss the reporting requirements under the Companies (Auditor's report) Order, 2003 where a company has defaulted in compliance of Section 58AA of the Companies Act, 1956 with regard to public deposits. *(8 marks) (Final Nov 2008)*

Answer

Under paragraph 4(VI) of Companies (Auditor's) Report Order 2003 as amended by Companies (Auditor's) Report (Amendment) Order, 2004, the audit report should include following matters:

In case company has accepted any deposits from public whether directives issued by the Reserve Bank of India and the provisions of sections 58 A and 58 AA or any other relevant provisions of the Act and the rules framed there under, where ever applicable, have been complied with. If not the nature of contraventions should be stated. If an order has been passed by Company Law Board or National Law Tribunal or Reserve Bank of India or any court or any other tribunal whether the same has been complied with or not ?

Section 58 AA deals with small depositors. As per this, a small depositor means a depositor who has deposited during a financial year a sum not exceeding rupees twenty thousand this section requires compliance of certain matters by the company.

Non compliance of section 58 AA occurs where company fails to intimate company law board, any default in repayment of deposit by small depositors or part there of or any interest thereupon. The auditor has therefore, to first determine whether there is any default in repayment of such deposits, when number of depositors are large, it may not be possible for an auditor to verify each repayment. In such situation, he should examine internal control system. He should obtain schedule of repayment to small depositors, and should make reasonable test checks of repayments made by the company. If during test check, default in repayment is noticed, he should see whether the same has been intimated to Company Law Board.

Over and above this, auditor should also examine regarding non compliance of Section 58 AA or rules made there under he should enquire, about any order passed by Company Law Board for contravention of section 58 AA

The auditor should obtain management representation to the effect whether:

(a) Company has complied with directives issued by Reserve Bank of India and provision of Section 58 AA or relevant rules. and

(b) Where an order has been passed by Company Law Board, the company has complied with requirements of the order

Question 25

Answer the following:

Comment whether the following Companies can be classified as a Small and Medium Sized Company (SMC) as per the Companies (Accounting Standards) Rules, 2006:

(i) A Pvt. Ltd., a subsidiary of a multinational company listed on London Stock Exchange. It has a turnover of Rs.12 crores and borrowings of Rs.5 crores.

(ii) B Pvt. Ltd. has a turnover of Rs.45 crores, other income of Rs.7 crores and bank borrowings of Rs.9 crores.

(iii) C Ltd. has appointed Merchant bankers to prepare a Red-herring prospectus for the purpose of filing the same with Securities and Exchange Board of India.

(12 Marks) (Final Nov 2008)

Answer

As per the Companies (Accounting Standards) Rules, 2006, "Small and Medium Sized Company" (SMC) means a company –

(i) Whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) Which is not a bank, financial institution or an insurance company;

(iii) Whose turnover (excluding other income) does not exceed Rs. 50 crores in the immediately preceding accounting year;

(iv) Which does not have borrowings (including public deposits) in excess of Rs. 10 crores at any time during the immediately preceding accounting year; and

(v) Which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Explanation: For the purposes of clause (f), a company shall qualify as a small and medium sized company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

(a) As per the definition of SMC, point (v), a company will be a SMC if it is not a holding or subsidiary company of another company which is not a SMC. Since A Pvt. Ltd. is a subsidiary of another company which is listed on London Stock Exchange (and is therefore not a SMC), A Pvt. Ltd., cannot be a SMC. The turnover and borrowings are not relevant in this case.

(b) As per the definition of SMC, point (iii), a company will be a SMC if it's turnover does not exceed Rs.50 crores or borrowings do not exceed Rs.10 crores. For calculating this turnover, other income is not to be included. Since B Pvt. Ltd., has a turnover of Rs.45 crores and borrowings of Rs.9 crores, it will satisfy the definition and can be classified as a SMC.

(c) As per the definition of SMC, point (i), a company will be a SMC if it is not listed or in the process of listing. Since C Pvt. Ltd., has appointed merchant bankers to prepare a Red-Herring Prospectus for the purpose of filing the same with SEBI, it is in the process of listing on a Stock Exchange. Hence, C Pvt. Ltd., cannot be classified as a SMC.

6

EDP AUDIT

Question 1

"Where the financial Accounting System has not been computerised, the auditor need not verify Computerised Management System ". *(8 Marks) (Final May 2000)*

Answer

Any typical organisation structure would involve different kinds of systems having regard to its nature of operational activities. Apart from the accounting information flow, there may be various other operational departments such as production, purchase, sales, computer department, maintenance, research and development, corporate services, etc. It is quite likely that certain aspects of the organisation have been inter-connected through computers and a central computerised management system is functional in the organisation. On the other hand, merely because the financial accounting system has not been computerised would not mean that the information generated in other sections of the organisation has no effect on manually maintained accounting records. The auditor's field of interest covers most of the business's activities. For although primarily he will be concerned with the financial accounting department activities, accounting information will be generated by many departments. And it is the auditor's task to see that all this information is reliable. It may be noted that AAS 6 (SA 400) on "Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit" makes it clear that the system of internal control extends beyond those matters which relate directly to the functions of the accounting system. Thus, operational controls such as quality control, work standards, budgetary control, quantitative control, etc. also acquire significance. This is where administrative controls also become important. The auditor should familiarise himself with the tasks being undertaken, the systems that have been developed and the reports generated from such applications. This would provide information which could improve the quality of his own work and enable him to judge better the quality of the accounting systems and internal checks which come within his preview. It would also assist him in making a qualitative judgement as to the state of affairs of the company and give an opportunity to review his audit programme to reduce routine work and improve quality by assuring that more time is spent by his assistants in other areas to improve quality and offer constructive suggestions. It is very important that the auditor must evaluate such control system also, which have bearing on reliability of financial information.

(NOTE: SA 315 issued in December, 2007. The date this Standard (along with SA 330) becomes effective, the existing Standard on Auditing (SA) 400, “Risk Assessments and Internal Control”, SA

310, "Knowledge of the Business", and SA 401, "Auditing in a Computer Information Systems Environment", issued in June 2002, April 2000 and January 2003, respectively, would stand withdrawn).

Question 2

(a) Describe the role of Computer-assisted Audit Techniques in EDP Environment.

(10 marks)

(b) Briefly explain the uses of test packs while conducting examination of accounts in the absence of audit trail. (6 marks) (Final May 2000)

Answer

(a) Role of Computer Assisted Audit Techniques in EDP Environment

Computer Assisted Audit Techniques (CAATs) refer to those auditing techniques that take assistance of a computer for being applied to an audit in a computer environment. The use of computer-assisted audit techniques may be required because:

(i) the absence of input documents (e.g. order entry in on-line systems), or the generation of accounting transactions by computer program (e.g. automatic calculation of discounts) may preclude the auditor from examining documentary evidence;

(ii) the lack of a visible audit trail will preclude the auditor from visually following transactions through the computerised accounting system; and

(iii) the lack of visible output may necessitate access to data retained on files readable only by the computer.

The auditor may however, decide to take advantage of the fact that much of the information is available in a form, which can be tested electronically. Alternatively, the auditor could be forced to abandon manual tests because there is no visible audit trail. In either case, the auditor must use either software or specially prepared audit data to test the inner workings of the company's system. This is known as auditing 'through the machine'. The methods by which this is done are known as 'computer assisted audit techniques' (CAATs).

CAATs enable the auditor to save time by examining data stored on computer media rather than on print-outs or other documents and, in some cases, to conduct tests which cannot be done manually because there is no visible evidence or audit trail. CAATs can be used for both compliance and substantive testing.

CAATs may be used in performing various auditing procedures, including:

(i) Tests of details of transactions and balances for example, the use of audit software to test all (or a sample) of the transactions in a computer file.

(ii) Analytical review procedures - for example, the use of audit software to identify unusual fluctuations of items.

(iii) Compliance test of general EDP controls - for example, the use of test data to test access procedures to the program libraries.

(iv) Compliance tests of EDP application controls - for example, the use of test data to test the functioning of a program procedure.

The most common types of CAATs used for audit purposes are discussed below:

(a) ***Audit Software:*** Audit software consists of computer program used by the auditor as a part of his auditing procedure to process data of audit significance. It may consist of:

(i) ***Package programs****:* These are generalised computer programs designed to perform data processing which includes reading computer files, selecting information, performing calculations, creating data files and printing reports in a format as specified by the auditor.

(ii) ***Purpose written programs****:* These are computer programs designed to perform audit tasks is specific circumstances. These programs may be prepared by the auditor, by the organisation or by an outside programmer engaged by the auditor. In some cases, the programs existing in the organisation may be used by the auditor in their original or in a modified state because it may be more economical and effective than developing independent program.

(iii) ***Utility programs****:* These are used by the organisation to perform common data processing functions, such as sorting, creating and printing files. These programs are generally not designed for audit purposes and therefore may not contain such features as automatic record counts or control totals.

(b) **Test Data**: Test data techniques are used in conducting audit procedures by entering data into the computer system of the organisation and comparing the results obtained with pre-determined results. For example:

(i) Test data used to test specific controls in computer programs, such as, on line password and data access controls.

(ii) Test transactions selected from previously processed transactions preferably historical data or data treated by the auditor to test specific processing characteristics of the organisation's computer system. Such transactions are generally processed separately from the entity's normal processing.

(iii) Test transactions used in an integrated test facility where a 'dummy' unit is established and to which test transactions are posted during the normal processing.

When test data is processed with the organisation's normal processing the auditor should ensure that the test transactions are subsequently eliminated from accounting records of the organisations.

(b) Use of Test Packs

"Test Packs" contain simulated transactions of all sorts of error conditions which can be used to test all the program controls. It consists of test data which will be processed in the same way as actual or live data. The data may either be fictitious as invented by the auditor or genuine data selected prior to processing. The essence of a test pack is that data will be chosen to test the workings of each control upon which reliance is to be placed. Data will include both that which falls outside the control parameters (and therefore should be printed out as an error or exception), and that which falls within the parameters (and therefore should be processed normally). For example:, assume that stock numbers range from 0 to 8,000, and that any stock movements with a number outside this range should be printed out as an error. So test data with numbers of 7,999 and 8,001 might be chosen. The latter should be printed out as an error, the former should be processed normally. Assume further that all debts over 60 days old should be printed out as exceptions on account of their being overdue. So a debt at 59 days, and one at 61 days might be chosen as the test data. The latter should be printed out as a exception, whereas the former should not appear on the exception report.

The results of the test data can be predetermined, and these anticipated results can then be compared with the error or exception reports produced by the computer. If this compliance testing reveals that the program controls can be relied upon, then it means that the resulting error and exception reports can be regarded as reliable. For, if a program control can be proved to work properly, it may be assumed that it will continue to work, unless fraudulently interfered with. And the chances of this will have been assessed during the examination of administrative controls.

The auditor will then have to satisfy himself that the appropriate action is taken on all error and exception reports. This would be determined by appropriate compliance testing, such as the review of a sample of error reports, to ensure that all errors have been removed, and, if necessary, reprocessed. If the results of this compliance testing are satisfactory, the auditor may then be satisfied that the chances of material error existing in the system are small, and may accordingly reduce the quantity of substantive testing for error, on the basis of reliable internal control.

The exception reports will be an important part of management controls over assets and liabilities, especially, in relation to concealed defalcations. And as such, the auditor will want to ensure that they are reliable. But they can also be of considerable audit benefit in substantive testing, particularly at the verification stage. For the exceptions are often exactly those items which the auditor himself would wish to examine. And he would otherwise have to extract such figures by hand. For example, a list of overdue debts would be of value in assessing the provision for doubtful debts.

Question 3

What is an Audit Trail? Briefly describe the special audit techniques using the computer as an audit tool. *(8 marks) (Final Nov 2000)*

Answer

Audit Trail: Changes in hardware and software of data processing system have significantly changed the approach to auditing. The work of an auditor would be hardly affected if "audit trail" is maintained i.e. if it were still possible to relate, on a 'one-to-one' basis, the original input with the final output. In a manual accounting system, it is possible to relate the recording of a transaction at each successive stage enabling an auditor to locate and identify all documents from beginning to end for the purposes of examining documents, totalling and cross-referencing.

In first and early second-generation computer systems, a complete audit trail was generally available. However, with the advent of modern machines, the EDP environment has become more complex. This led to use of exception reporting by the management which effectively eliminated the audit trail between input and output. The lack of visible evidence may occur at different stages in the accounting process, for example:

(i) Input documents may be non-existent where sales orders are entered online. In addition, accounting transactions, such as discounts and interest calculations, may be generated by computer programmes with no visible authorisation of individual transactions.

(ii) The system may not produce a visible audit trail of transactions processed through the computer. Delivery notes and suppliers' invoices may be matched by a computer programme. In addition, programmed control procedures, such as checking customer credit limits, may provide visible evidence only on an exception basis. In such cases, there may be no visible evidence that all transactions have been processed.

(iii) Output reports may not be produced by the system. In addition, a printed report may only contain summary totals while supporting details are retained in computer files.

Special Audit Techniques: In the absence of audit trail, the auditor needs the assurance that the programmes are functioning correctly in respect of specific items by using special audit techniques. The absence of input documents or the lack of visible audit trail may require the use of Computer Assisted Audit Techniques (CAATs) i.e. using the computer as an audit tool. The effectiveness and efficiency of auditing procedures may be enhanced through the use of CAATs. Popularly, two common types of CAATs are in vogue, viz., test packs or test data and audit software or computer audit programmes. Normally speaking, special audit techniques may be used under the following circumstances:

(i) to ensure the correct functioning of important programme controls;

(ii) to overcome losses of audit trail;

(iii) to reduce audit costs or increase the efficiency of the audit.

Audit Software: Audit software consists of computer programmes used by the auditor, as part of his auditing procedures, to process data of audit significance from the entity's accounting system. It may consist of package programmes, purpose-written programmes, and utility programmes. Regardless of the source of the programmes, the auditor should substantiate their validity for audit purposes prior to use.

(i) Package programmes are generalised computer programmes designed to perform data processing functions which include reading computer files, selecting information, performing calculations, creating data files and printing reports in a format specified by the auditor.

(ii) Purpose-written programmes are computer programmes designed to perform audit tasks in specific circumstances. These programmes may be prepared by the auditor, by the entity or by an outside programmer engaged by the auditor. In some cases, existing entity programmes may be used by the auditor in their original or in a modified state because it may be more efficient than developing independent programmes.

(iii) Utility programmes are used by the entity to perform common data processing functions, such as sorting, creating, and printing files. These programmes are generally not designed for audit purposes and, therefore, may not contain such features as automatic record counts or control totals.

Test Data: Test data techniques are used in conducting audit procedures by entering data (e.g., a sample of transactions) into an entity's computer system, and comparing the results obtained with predetermined results. This enables to ascertain whether the controls residing in the hardware and in the programmes are operating correctly. Test data is used to test specific controls in computer programmes, such as online password and data access controls. Examples of such uses are:

(i) Test transactions selected from previously processed transactions or created by the auditor to test specific processing characteristics of an entity's computer system. Such transactions are generally processed separately from the entity's normal processing.

(ii) Test transactions in an integrated test facility where a "dummy" unit (e.g., a department or employee) is established and to which test transactions are posted during the normal processing cycle.

When test data is processed with the entity's normal processing, the auditor should ensure that the test transactions are subsequently eliminated from the entity's accounting records.

Question 4

Write short notes on the following:

(i) Decision Tree

(ii) Utility Routine *(4 $\times$ 2 = 8 marks) (Final Nov 2000)*

(iii) Test Packs *(4 marks) (Final May 2006)*

Answer

(i) Decision Tree: A decision tree is a graphic display of the relationship between the present position and future events; future events and their consequences. The sequence of events is mapped out over time in a format similar to the branches of a tree. The decision tree approach gets its name because of the resemblance with a tree having number of branches. A decision tree represents a decision problem as a series of decisions to be taken under conditions of uncertainty. A present decision depends upon the past decision and their outcomes. The decision trees are the diagrams that permit the various decision alternatives, their outcomes and probabilities of their occurrences to be mapped in a clear fashion.

In a typical decision tree, therefore, the project is broken down into clearly defined stages, and the possible outcomes at each stage are listed along with the probabilities and cash flows effect of each outcome. Important steps while constructing a decision tree in respect of an investment proposal are: definition of the investment proposal, identification of decision alternatives, identification of decision points, chance of events and other data, location on the decisions tree branches of the relevant data such as projected cash flow, expected present value, and selection of the best alternatives. This approach is extremely useful in handling sequential investments and working backwards, eliminating unprofitable branches and determination of optimum decision at various decision points.

The major advantage of a decision tree is that it brings out the implicit assumptions and calculations for all to see, raise questions and revise. It also allows a decision maker to visualise assumptions and alternatives in the graphic form which are easy to understand. The disadvantages, however, are that the diagram becomes complicated and cumbersome as more and more variables are added. The addition of interdependent alternatives and variables does not only present a queer picture but also makes calculation time consuming.

(ii) Utility Routines: Utility Routines are generally supplied by the computer manufacturer and are available for call up by the operating system. These routines play a key role in an electronic data processing. These are generalised programmes that perform necessary but routine jobs in a computer installation. These routines are sufficiently flexible to handle needs of all users. They are controlled by parameters to indicate the particular characteristics of the data or the requirements. Generally, three types of utility routines are made available by computer vendors.

Data set utilities are used to manipulate files of stored data. One data set utility programme might merge or combine data from more than one file of stored data. Another might copy a file of data to another file. A third might instruct the computer to print selected portions of a set of data. A fourth might sort file records into a desired sequence.

System utilities are used to simplify the task of knowing where data are stored in a computer file. One utility routine might add data to a file, name the set of data, and catalogue the data set to distinguish it from other data sets. Another utility routine might list the catalogue of data sets, showing where particular data is stored in a file. A third might label magnetic tapes. A fourth might accumulate and report errors incurred during the processing of magnetic disk and tape.

Independent utilities perform such housekeeping functions as preparing a back up copy of the contents stored on a magnetic disk file or analysing a magnetic disk for defective tracks. This type of a utility routine performs the needed diagnostic tests.

(iii) Test Packs: Test pack is a technique to determine the correctness of the computer programming used to record transactions through the computer. Preparation of test pack requires a great deal of expertise. It may be prepared by the auditor himself with the help of the entity's staff or by the Internal Control department of the entity. Normally test packs are used where:

(i) a significant part of the control system is embodied in the programme;

(ii) there are gaps in audit trail making it difficult to trace output from input and to verify intermediate calculation; and

(iii) the volume of records is large, so that it may be more economical and more effective to use test packs rather than to trace the transactions manually.

The operations of a test pack involve following steps:

(i) The auditor or the Internal Audit Department prepares a set of special data covering different types of transactions containing valid and invalid conditions.

(ii) Data will include both that falling outside the control parameters (and printed out as an error or conception) and that falling within the parameters (and hence should be processed normally).

(iii) The test data are seen on the clients' computer with the client's programme but under audit supervision.

(iv) The results of the test data are also prepared separately, independent of the computer/programme, and are compared with the results obtained by running the programme through the computer.

(v) If the results are identical, reliability of the computer programme is proved.

Question 5

A limited company having turnover of approximately Rs.50 crores uses a tailor made accounting software package. In the said package, all transactions are recorded, processed and the final accounts generated from the system. The management tells you that in view of the voluminous nature of day books, there is no need to print them and that audit can be conducted on the computer itself. The management further assures you that any 'query based reports' as required can be generated and printed. As a statutory auditor of the company, enumerate the procedures you would adopt to conduct the audit. (16 marks) (Final May 2001)

Answer

A key feature of the accounting software package used by the company definitely involves the absence of a clear audit trail. In other words, transactions cannot be easily traced or co-related from the individual supporting documents of those transactions. Moreover, the management does not wish to print the daybooks in view of the voluminous nature since it may involve extensive costs. This has naturally led to extensive dependence by management upon the "exception reporting" principle.

From the auditor's point of view, it must also be conceded, the exception reports in the form of 'query-based reports' which isolate the above data provide him with the very material that he requires for most of his verification work. The only problem which it raises, and it is a serious one, is that he cannot simply assume that the programmes which produce the exception reports are reliable in respect of the following factors:

(i) operating accurately;

(ii) printing out all the exceptions which exist; and

(iii) bound by programmed control parameters which meet the company's genuine internal control requirements.

In view of the above, whether management relies upon exception reports, it effectively eliminated the audit trail between input and output and the auditor is forced to test the invisible processes which purport to embody the controls, and produce the output such as it is. These tests, which invariably involve the use by the auditor of the computer itself, are known as tests through the machine. In the 'through the machine' approach, the auditor starts by proving the accuracy of the input data, and then thoroughly examines (by applying tests) the processing procedures with a view to establishing the following that:

(i) all input is actually entered into the computer.

(ii) neither the computer nor the operators can cause undetected irregularities in the final reports.

(iii) the programmes appear, on the evidence of rejection and exception routines, to be functioning correctly.

(iv) all operator intervention during processing is logged and scrutinised by the DP manager.

The auditor in such circumstances will have to first evaluate the existing controls. For the same, he has to do the following:

(i) Evaluate the internal control system especially the controls and checks existing for recording the transactions, i.e., he has to verify at what level transactions can be entered into the system and what checks are available to prevent any unauthorised data entry and for rectifying errors/omissions in the transactions entered.

(ii) Evaluate at what level there is authority given for modification of transactions already entered. Is there any authority given only to a senior employee to carry out modifications? Or is it that once transactions are entered and validated no further modifications are possible thereto.

(iii) Whether there is a provision in the software for carrying out an on line audit of transactions, i.e. whether there a separate module in the package, where a separate password given to the auditor and once he has seen and approved a particular transaction/set of transactions, the same would be locked and no modifications would be possible by anyone (including the senior most employee) in the company.

(iv) Whether there are proper procedures for backup of data on a regular basis and whether the said procedures are being strictly followed.

(v) In case of any loss of data whether there is a clear defined recovery procedure to minimise the loss of data due to power failures or any human errors.

(vi) The auditor may introduce some dummy data into the system and see the results obtained.

After the auditor has evaluated the above procedures, he has to prepare an audit plan depending on the results obtained from his earlier evaluation. Since the daybooks are not being printed, the plan can contain procedures wherein data is verified directly on the computer from the vouchers/invoices, etc. The audit plan will also require a lot of analytical procedures to be performed. Depending on the importance of various expense heads and other important account heads, the auditor will also obtain various reports from the system depending on various queries that he would have to identify. Some illustrative reports can be:

(i) To check whether proper classification is done for revenue/capital - a report can be obtained of all purchases (not being raw materials or other routine purchases) exceeding Rs. one lakh.

(ii) To check whether all freight outward bills are accounted for a report containing a month-wise co-relation between goods despatched and freight amount paid. The same can be further co-related with the freight rates obtained from the bills.

Once the auditor has performed the above procedures, he would be able to form an opinion whether reliance can be placed on the accounting systems and the data recorded. If the auditor finds that reliance cannot be placed on the systems he can inform the management about the fact and also that the daybooks, etc., will need to printed to allow him to conduct the audit. The finalisation procedures to be followed even under this system would remain more or less similar to other accounting systems. The auditor can obtain reports of depreciation on fixed assets, inventory valuation and using the normal procedures find out whether reliance can be placed on them, e.g., if while valuing stocks the system is using the LIFO method, the same would not be acceptable and will need to be modified. Similarly depreciation calculations will have to verified on a random basis to find out its reliability.

Question 6

"On-line real time processing system and batch processing system have their inherent strengths and weaknesses." Please comment. *(8 marks) (Final Nov 2001)*

Answer

On-line Real Time Processing System vs. Batch Processing System: On-line computer systems are computer systems that enable users to access data and programmes directly through terminal devices. Such systems may comprise mainframe computers, minicomputers or a network of connected PCs. When the entity uses an on-line computer system, the technology is likely to be complex and linked with the entity's strategic business plans. On-line computer systems may be classified according to how information is entered into the system, how it is processed and when the results are available to the user. In an on-line real-time processing system, individual transactions are entered at terminal devices, validated and used to update related computer files immediately. An example is the application of cash receipts directly to customers' accounts. The results of such processing are then available immediately for inquiries or reports. In an on-line real-time (OLRT) processing system, transactions are entered as they occur, and are processed as they are entered. These systems form the heart of management information systems. Given the continuous updating of the database as transactions are entered, the status of such files as accounts receivable, accounts payable, and inventory may be determined at any time.

In a system with on-line batch processing, individual transactions are entered at a terminal device, subjected to certain validation checks and added to a transaction file that contains other transactions entered during the period. Later, during a subsequent processing cycle, the transaction file may be validated further and then used to update the relevant master-file. For example, journal entries may be entered and validated on-line and kept on a transaction file, with the general ledger master-file being updated on a monthly basis. Inquiries of, or reports generated from, the master-file will not include transactions entered after the last master-file update. In a batch processing system which is not on-line, transactions are accumulated and processed in group sales orders for the day, invoices to be recorded, and daily cash receipts might each be viewed as a "batch" of transactions, to be processed as a group. Batch processing systems are distinguished by their relative simplicity and reliability. They do not process transactions as quickly as the more advanced systems, nor do they possess the potential for providing timely information concerning the files updated by transactions processing. Given these limitations, the use of networked PCs terminals has become widespread, even among small entities. Batch processing systems are rarely found in today's systems environment.

Although powerful in terms of information capability, OLRT systems are more complex than batch processing systems. Moreover, they ordinarily do not provide the extent of audit trail documentation produced by batch system and for this they are more difficult to audit in terms of obtaining satisfaction concerning the existence of necessary controls, and of designing substantive testing procedures.

Conversely, in a batch processing system, the transaction are accumulated and processed in batches or groups. Control totals, both monetary and documentary, are also available for review to ensure completeness and accuracy of data being processed. The system is simple and reliable. However, its deficiency lies in the MIS is not updated on a concurrent basis and, therefore, information is not available on a timely basis.

Accordingly, it is a question of cost-benefit analysis as to which system will be more preferable to an entity.

Question 7

Indicate the control procedures which the auditor should adopt in applying CAAT (Computer Assisted Audit Technique) in an audit under EDP environment. (16 marks) (Final May 2002)

Answer

Computer Assisted Auditing Techniques (CAATs) involve performing audit procedures while conducting audit through the computer. Audit software and Test Data are two common type of

CAATs. Using CAATs involves taking various measures including monitoring so that the use of CAATs by the auditor provides reasonable assurance that the audit objectives and detailed specifications of CAATs have been met. It is to be seen that CAATs are not manipulated by staff of the entity. The specific procedures necessary to control the use of a CAATs will depend on the particular application. In establishing control, the auditor should consider the necessity to:

(a) Approve technical specifications and carry out a technical review of work pertaining to CAAT application.

(b) Review the General EDP controls operating in the organisation which might contribute to the integrity of the CAAT. For example, control over program changes and access to computer files. When such controls cannot be relied upon to ensure the integrity of the CAAT, the auditor may consider processing the CAAT application at another suitable computer facility.

(c) Ensure appropriate integration of the output into the audit process.

Procedure to control audit software applications are as follows:

(i) Participation in the design and testing of computer programmes.

(ii) Checking the coding of the programme to see that it conforms to programming specifications.

(iii) Running the audit software on small test files before running the same on main data files.

(iv) Ensuring that correct files are used in the programme by cross-checking with external evidence.

(v) Review output and control information to ensure that audit software functioned as planned.

(vi) Existence of appropriate security measures to guard against manipulation.

Apart from the above control procedures for audit software, the auditor should carry out certain control procedures for Test Data on the following lines:

(a) Controlling the sequence of submissions of test data where it spans several processing cycles.

(b) Performing test runs containing small amounts of test data before submitting the main audit test data.

(c) Predicting the results of the test data and comparing it with the actual test data output, for the individual transactions and in total.

(d) Confirming that the current version of the programs was used to process the test data.

(e) Obtaining reasonable assurance that the programs used to process the test data were used by the entity throughout the applicable audit period.

When using a CAAT, the auditor may require the cooperation of the entity's staff who have extensive knowledge of the computer installation. In such circumstances, the auditor should have reasonable assurance that the entity's staff did not improperly influence the results of the CAAT.

Question 8

Answer the following:

Discuss some problems that will be encountered in an EDP system in implementation of internal control. (10 marks) (Final Nov 2002)

Answer

Problems in Implementation of Internal Control in EDP System: The internal controls over computer processing, which help to achieve the overall objectives of internal control, include both manual procedures and procedures designed into computer programs. Such manual and computer control procedures comprise the overall controls affecting the EDP environment (general EDP controls) and the specific controls over the accounting applications (EDP application controls). The following problems normally arise in implementation of internal control in an EDP system:

(i) ***Separation of duties***: In a manual system, separate individuals are responsible for initiating transactions, recording them and the custody of the assets. This separation of duties helps in preventing or detecting errors and other irregularities. In the EDP environment, this traditional segregation of duties may not always apply. For example, a program may reconcile a vendor invoice against a receiving document and print a cheque for the amount owed to a creditor. Thus, the program is performing functions that in a manual systems would be considered incompatible.

(ii) ***Delegation of authority and responsibility***: Normally a clear line of authority and responsibility is essential aspect of control in any system. In a computer system, however, delegating authority and responsibility may prove difficult because some resources are shared among multiple users. When multiple users have access to the same data, it is not always easy to trace or find out who is responsible for any corruption of the data and for identifying and correcting errors. Some organizations have attempted to overcome these problems by designating a single user as the owner of data. This user assumes ultimate responsibility for the integrity of the data.

(iii) ***Competent and trustworthy personnel***: A good EDP system requires competent and trustworthy personnel for its flawless operation. Highly skilled personnel are needed to develop, modify, maintain and operate the computer systems. Getting competent and trustworthy personnel for working in the EDP environment is, however, difficult as well-trained and experienced people in this field are normally in short supply.

(iv) ***System of authorizations***: Any good system of internal control has a system of authorizations at various levels. General authorizations establish policies for the organization to follow; for example, a fixed price list is issued for personnel to use when products are sold. Specific authorisations apply to individual transactions; for example, acquisitions of major capital assets may have to be approved by the board of directors. In a manual system, auditors can evaluate the adequacy of procedures for authorisation by examining the work of employees. In a computer system, however, the procedures are often embedded within a computer program. In such a case when evaluating the adequacy of authorisation procedures, auditors will not only have to examine the work of the employees but also find out the veracity of program processing.

(v) ***Adequate documents and records***: In a manual system, adequate documents and records are necessary to provide an audit trail of the various activities within the system. In a computer system, however, documents may not be used to support the initiation, execution and recording of some transactions. There would be therefore no visible audit trail to trace a transaction. This absence of a visible audit trail will not hinder the auditor's work if systems are designed to maintain a record of all events and there is a means of accessing these records. The auditor therefore needs to find out whether the computer system environment provides for such a record of the events and also enables access to the records.

(vi) ***Physical control over assets and records***: Physical control over access to their assets and records is critical in both manual systems as well as computer systems. In computer systems, however, there is a concentration of the data processing assets and records of an organisation. This means that in such an environment, if any fraud is to be perpetrated, the person does not have to go to long distances but only have access to the computer systems. Hence it is important that a good EDP environment restricts access to the data processing assets and records.

(vii) ***Adequate management supervision***: In a manual system, the management supervision of employee activities is relatively simple because the managers and employees are often at the same physical location. In computer systems, however, the employees handling the data processing may be remotely located. Supervisory controls must therefore be built into the computer system to compensate for the controls that usually can be exercised through observation and inquiry.

(viii) ***Comparing recorded accountability with assets***: In any good system, the data and their assets that the data purports to represent should be compared to determine the completeness and accuracy of the data. In a manual system, there is normally an independent staff to prepare the basic data for such comparison. In a computer system, however, programmes are used to prepare this data. Therefore, care must be taken that there are no unauthorised modifications to this programs or to any of the data files database programs use otherwise the irregularity may not be discovered.

Question 9

Discuss the control procedures which the auditor should adopt in applying CAAT (Computer Assisted Audit Technique) in an audit under EDP environment (8 marks) (Final Nov 2003)

Answer

Control Procedures and Computer-Assisted Audit Techniques (CAATs): The common types of CAATs are audit software and test data. Audit software consists of computer programmes used by the auditor to process data of audit significance from the entity's accounting systems. It may consist of package programmes, purpose-written programmes and utility programmes. Regardless of the source of programme, the auditor should substantiate their validity for audit purposes prior to use. Test Data techniques on the other hand are used in conducting audit procedures by entering data (a sample transactions) into an entity's computer systems and comparing the results obtained with the predetermined results. Test data is used to test specific controls in computer programmes, such as, on line password and data access.

Controlling the CAAT Application: The use of a CAAT should be controlled by the auditor to provide reasonable detailed specifications of the CAAT have been met and that the CAAT is not improperly manipulated by the entity's staff. The specific procedures necessary to control the use of a CAAT will depend on the particular application in establishing audit control which require the auditor should consider the need to –

(a) Approve the technical specifications and carry out a technical review of the work involving the use of the CAAT.

(b) Review the entity's general IT controls which may contribute to the integrity of the CAAT, e.g., control over programme changes and access to computer files. When such controls cannot be relied upon to ensure the integrity of the CAAT, the auditor may consider processing the CAAT applications at another suitable computer facility.

(c) Ensure appropriate integration of the output by the auditor into the audit process.

Procedures carried out by the Auditor to control Audit Software Application

(a) Participating in the design and testing of the computer programmes.

(b) Checking the coding of the programme to ensure that it conforms with detailed programme specifications.

(c) Requesting the entity's computer staff to review the operating system instructions to ensure that the software will run in the entity's computer installation.

(d) Running the audit software on small test files before running on the main data files.

(e) Ensuring that the correct files were used, e.g. by checking with external evidence, such as control totals maintained by the user.

(f) Obtaining evidence that the audit software functioned as planned, for example, returning output and control information.

(g) Establishing appropriate security measures to safeguard against manipulations of the entity's data files.

The presence of the auditor is not necessarily required at the computer facility during the running of a CAAT to ensure appropriate control procedures. However, it may provide practical advantages, such as being able to control distribution of the output and ensuring the timely corrections of errors.

Procedures carried out by the Auditor to Control Test Data Applications

(a) Controlling the sequence of submissions of test data where it spans several processing cycles.

(b) Performing test runs containing small amounts of test data before submitting the main audit test data.

(c) Predicting the results of the test data and comparing it with the actual test data output, for the individual transactions and in total.

(d) Confirming that the answered version of the programmes was used to process the test data.

(e) Obtaining reasonable assurance that the programmes used to process the test data were used by the entity throughout the applicable audit period.

When using a CAAT, the auditor may require the co-operation of the entity's staff who have extensive knowledge of the computer installation. In such circumstances, the auditor should have reasonable assurance that the entity's staff did not improperly influence the results of the CAAT. Finally, the standard of working papers and retention procedures for a CAAT should be consistent with that on the audit as a whole. It may be convenient to keep the technical papers relating to the use of the CAAT separate from the other audit working papers. The working papers should contain sufficient documentation to describe the CAAT application.

Question 10

State the important characteristics of an effective computer audit programme System

(8 marks) (Final May 2004)

Answer

Characteristics of an effective computer audit program system: Normally, the computer audit program developed for general purposes shall have to customised according to needs of the organisation. However, an examination of following features is necessary to ensure that it is effective:

1. ***Simplicity**:* The system should be simple to use and eliminate the need for remembering countless details normally required in writing or revising computer programs.

2. ***Understandability**:* The system should be readily understandable by members of the audit staff, even those with little computer expertise. The capabilities of the system should be known and it should be easy to use. Coding forms provided should not be difficult to understand.

3. ***Adaptability**:* The system should be capable of writing computer audit programs for the various types of computers used in the company or expected to be acquired. Thus the package will be usable if the equipment is changed in the future.

4. ***Vendor technical support**:* In considering the types of package to be acquired, it is important that the vendor provides adequate support. This includes assisting in the initial installation and providing adequate documentation. In addition, training provided for the audit staff is important. Also, maintenance service should be furnished, and provision made for future revisions in the programs.
5. ***Statistical sampling capability**:* Since statistical sampling is an important application in auditing, the package should be able to perform the various statistical routines. This should include the selection of items on a random basis, determination of sample size, and evaluation of results at different confidence levels. In addition to simple random sampling and stratified sampling, it should have routines for more complex sampling such as cluster and multistage sampling.
6. ***Acceptability**:* The system should be acceptable to both the auditors and to computer centres. For the auditors the programs should be easily carried to the site and practical to use. For the computer centre the programs should be compatible with the system and be capable of minimum interference with normal routines.
7. ***Processing Capabilities**:* The package should be able to process many different types of applications. For example, it should accept all common file media and process multiple file input. It should have the capability for extended data selection and stratification. It should have the ability to operate under multiprogramming situations. It should have powerful, generalized audit commands.
8. ***Report Writing**:* The package should have a strong report writing function. This should include the ability to prepare multiple reports in a single program run and to generate flexible output report formats.

Question 11

(a) State the specific problems, which may arise in the implementation of internal control in an EDP system. (8 marks)

(b) What are the characteristics of 'On-line Computer System'? (4 marks)

(c) Explain : Tagging and Tracing (4 marks) (Final Nov 2004)

Answer

(a) Specific problems of EDP relating to Internal Control: In an EDP system, the following specific problems arise in the implementation of internal control:

(i) ***Separation of duties*:** In a manual system, separate individuals are responsible for initiating transactions, recording transactions, and custody of assets. As a basic control, separation of duties prevents or detects errors and irregularities. In a computer system, however, the traditional notion of separation of duties does not always apply. For example, a program may reconcile a vendor invoice against a receiving document and print a cheque for the amount owed to a creditor. Thus, the program is performing functions that in a manual systems would be considered incompatible. In minicomputer and PC environments, separation of incompatible functions may be even more difficult to achieve. Some minicomputers and PCs allow users to change programs and data easily; furthermore, they provide no record of these changes. If the minicomputer or PC does not have an inbuilt capability to provide a secure record of changes, it may be difficult to determine whether incompatible functions have been performed by systems users.

(ii) ***Delegation of authority and responsibility***: A clear line of authority and responsibility is an essential control in both manual and computer systems. In a computer system, however, delegating authority and responsibility in an unambiguous way may be difficult because some resources are shared among multiple users. For example, one of the objectives of using a database management system is to provide multiple users with access to the same data, thereby reducing the control problems that arise with maintaining redundant data. When multiple users have access to the same data and integrity of the data is somehow violated, it is not always easy to trace who is responsible for corrupting the data and who is responsible for identifying and correcting the error. Some organizations have attempted to overcome these problems by designating a single user as the owner of data. This user assumes ultimate responsibility for the integrity of the data.

(iii) ***Competent and trustworthy personnel***: The technology of data processing is now exceedingly complex-much more complex than in the days of manual systems. Highly skilled personnel are needed to develop, modify, maintain, and operate today's computer systems. Thus, the existence of competent and trustworthy personnel becomes even more important when computer systems are used to process an organization's data, since a relatively small number of individuals assume major responsibility for the integrity of the data.

(iv) ***System of authorizations***: Management issues two types of authorizations to execute transactions. General authorizations establish policies for the organization to follow: for example, a fixed price list is issued for personnel to use when products are sold. Specific authorisations apply to individual transactions: for example, acquisitions of major capital assets may have to be approved by the board of directors. In a manual system, auditors evaluate the adequacy of procedures for authorisation by examining the work of employees. In a computer system authorisation procedures often are embedded within a computer program. For example, the order entry module in a sales system may determine the price to be charged to a customer. Thus, when evaluating the adequacy of authorisation procedures, auditors have to examine not only the work of employees but also the veracity of program processing.

(v) ***Adequate documents and records***: In a manual system, adequate documents and records are necessary to provide an audit trail of activities within the system. In computer systems, documents may not be used to support the initiation, execution and recording of some transactions. For example, in an on line order entry system customers orders received by telephone may be entered directly into the system.

Similarly, some transactions may be activated automatically by a computer system: For example, an inventory replenishment program may initiate purchase orders when stock levels fall below a set amount. Thus, no visible audit or management trail may be available to trace the transaction. The absence of a visible audit trail is not a problem for the auditor provided that systems have been designed to maintain a record of all events and there is a means of accessing these records. In well-designed computer systems, audit trails are often more extensive than those maintained in manual systems.

(vi) ***Physical control over assets and records*:** Physical control over access to assets and records is critical in both manual systems and computer systems. Computer systems differ from manual systems, however, in the way they concentrate the data processing assets and records of an organization. For example, in a manual system, a person wishing to perpetrate a fraud may be maintained at a single site- the data processing installation. Thus, the perpetrator does not have to go to physically distance locations to execute the fraud.

(vii) ***Adequate management supervision*:** In a manual system management supervision of employee activities is relatively straight forward because managers and employees are often at the same physical location. In computer systems, however, data communications may be used to enable employees to be closer to the customers they service. Thus, supervision of employees may have to be carried out remotely. Supervisory controls must be built into the computer system to compensate for the controls that usually can be exercised through observation and inquiry.

(viii) ***Comparing recorded accountability with assets*:** Periodically, data and the assets that the data purports to represent should be compared to determine whether incompleteness or inaccuracies in the data exist or shortages in the assets have occurred. In a manual system, independent staff prepares the basic data used for comparison purposes. In a computer system, however, programs are used to prepare this data. For example, programs may sort an inventory file by warehouse location and prepare counts by inventory item at different warehouses. If unauthorized modifications occur to the programs or data files that the programs use, an irregularity may not be discovered.

(b) Characteristics of 'On-line Computer System'

(i) ***Validation Checks***: When data are entered on-line, they are usually subject to immediate validation checks. Data failing this validation would not be accepted and a message may be displayed on the terminal screen, providing the user with the ability to correct the data and re-enter the valid data immediately. For example, if the user enters an invalid inventory part number, an error message will be displayed enabling the user to re-enter a valid part number.

(ii) ***On-Line Access**:* Users may have on-line access to the system that enables them to perform various functions, e.g., to enter transactions and to read, change or delete programs and data files through the terminal devices. Unlimited access to all of these functions in a particular application is undesirable because it provides the user with the potential ability to make unauthorised changes to the data and programs. The extent of this access will depend upon such things as the design of the particular application and the implementation of software designed to control access to the system.

(iii) ***Transaction Trail***: An on-line computer system may be designed in a way that does not provide supporting documents for all transactions entered into the system. However, the system may provide details of the transactions on request or through the use of transaction logs or other means. Illustrations of these types of systems include orders received by a telephone operator who enters them on-line without written purchase orders, and cash withdrawals through the use of automated teller machines.

(iv) ***Programmer Access****:* Programmers may have on-line access to the system that enables them to develop new programs and modify existing programs. Unrestricted acess provides the programmer with the potential to make unauthorised changes to programs and obtain unauthorised access to other parts of the system. The extent of this access depends on the requirements of the system. For example, in some systems, programmers may have access only to programs maintained in a separate program development and maintenance library; whereas, in emergency situations which require changes to programs that are maintained on-line, programmers may be authorised to change the operational programs. In such cases, formal control procedurs would be followed subsequent to the emergency situation to ensure appropriate authorisation and documentation of the changes.

(c) **Tagging and Tracing:** It is a technique better than Integrated Test Data Facility. It involves tagging the client's input data in such a way that relevant information is displayed at key points. It uses the actual data, and so the question of elimination of 'special entries' test data designed under Integrated Test Data Facility does not arise. The hard copy, so produced is available only to the auditor and may describe such inputs as hours worked in a pay period in excess of 50; or sales orders processed in excess of Rs.1,00,000. This enables the auditor to examine transactions at the intermediate steps in processing. The advantage of the tagging and tracing approach lies in the use of actual data and elimination of the need for reversing journal entries. The disadvantage is that the erroneous data will not necessary be tagged. An effective combination approach may be to use the ITF approach (integrated test facility) for a few hypothetical transactions and the tagging and tracing approach to follow line data through a complex system.

Question 12

Answer the following:

In determining whether to use Computer Assisted Auditing Techniques (CAATs), what are the factors that a statutory auditor has to consider? *(6 marks) (Final May 2005)*

Answer

Consideration of Factors in Use of CAATs: In determining whether to use CAATs, the auditor should consider the following factors:

(i) ***Availability of sufficient IT knowledge and expertise***: It is essential that members of the audit team should possess sufficient knowledge and experience to plan, execute and use the results of CAAT. The audit team should have sufficient knowledge to plan, execute and use the results of the particular CAAT adopted.

(ii) ***Availability of CAATs and suitable computer facilities and data in suitable format***: The auditor may plan to use other computer facilities when the use of CAATs on an entity's computer is uneconomical or impractical, for example, because of an incompatibility between the auditor's package programme and entity's computer.

(iii) ***Impracticability of manual tests due to lack of evidence***: Some audit procedures may not be possible to perform manually because they rely on complex processing (for example, advanced statistical analysis) or involve, amounts of data that would overwhelm any manual procedure.

(iv) ***Impact on effectiveness and efficiency in extracting a data***: It includes selection of samples, applying analytical procedures, time involved in application of CAAT, etc.

(v) Time constraints in certain data, such as transaction details, are often kept for a short time and may not be available in machine-readable form by the time auditor wants them. Thus, the auditor will need to make arrangements for the retention of data required, or may need to alter the timing of the work that requires such data.

Question 13

State the important characteristics of an effective system of Computer Audit Programme.

(8 marks)(Final Nov 2006)

Answer

Important characteristics of an effective system of computer audit program

(i) The system has to be simple to use and eliminate the need to remember countless details normally required in writing or revising computer programs.

(ii) It has to be easily understandable even by those with little computer expertise and easy to use.

(iii) It has to be capable of being used with different configuration of computers.

(iv) The package has to include adequate support at the time of installation, provide adequate training to the staff and to provide documentation. There should be a provision for future revision of the program.

(v) The package should have statistical sampling capability.

(vi) The system has to be acceptable to all users in terms of easy execution and compatible with the existing system.

(vii) The program has to be capable of processing different types of applications.

(viii) The program should have strong report writing function including the ability to prepare multiple reports in a single program run and to generate flexible output report formats.

Question 14

Write a short notes on - Factors to consider in determining the use of Computer Assisted Audit Techniques (CAATs). *(4 marks) (Final May 2007)*

Answer

Factors to consider in determining the use of Computer Assisted Audit Techniques

(i) The IT knowledge, expertise and experience of the audit team.

(ii) The availability of CAATs and suitable computer facilities and data.

(iii) The impracticability of manual tests due to complex processing needed.

(iv) Effectiveness and efficiency in evaluating evidence involving large population.

(v) Time constraints.

The above is in consonance with the guidance note on Computer Assisted Audit Techniques.

Question 15

"The method of collecting Audit evidence and evaluating the same changes drastically under EDP Auditing". Comment on the above. *(8 marks) (Final Nov 2007)*

Answer

Effects of EDP Auditing: Auditor must provide a competent, independent opinion as to whether the financial statements records and report a true and fair view of the state of affairs of an entity. However, computer systems have affected how auditors need to collect and evaluate evidence. These aspects are discussed below:

(1) Changes to Evidence Collection - Collecting evidence on the reliability of a computer system is often more complex than collecting evidence on the reliability of a manual system. Auditors have to face a diverse and complex range of internal control technology that did not exist in manual system, like:

(a) accurate and complete operations of a disk drive may require a set of hardware controls not required in manual system,

(b) system development control include procedures for testing programs that again are not necessary in manual control.

Since, Hardware and Software develop quite rapidly, understanding the control technology is not easy. With increasing use of data communication for data transfer, research is focused an cryptographic controls to project the privacy of data. Unless auditor's keep up with these developments, it will become difficult to evaluate the reliability of communication network competently.

The continuing and rapid development of control technology also makes it more difficult for auditors to collect evidence on the reliability of controls. Even collection of audit evidence through manual means is not possible. Hence, auditors have to run through computer system themselves if they are to collect the necessary evidence. Though generalized audit software are available the development of these tools cannot be relied upon due to lack of information. Often auditors are forced to compromise in some way when performing the evidence collection.

(2) Changes to Evidence Evaluation - With increasing complexity of computer systems and control technology, it is becoming more and more difficult for the auditors to evaluate the consequences of strength and weaknesses of control mechanism for placing overall reliability on the system.

Auditors need to understand:

(a) whether a control is functioning reliably or multi functioning,

(b) traceability of control strength and weakness through the system. In a shared data environment a single input transaction may update multiple data item used by diverse, physically disparate user, which may be difficult to understand.

Consequence of errors in a computer system is a serious matter as errors in computer system tend to be deterministic, i.e., an erroneous program will always execute data incorrectly. Moreover, the errors are generated at high speed and the cost and effort to correct and rerun program may be high. Errors in computer program can involve extensive redesign and reprogramming. Thus, internal controls that ensure high quality computer systems should be designed implemented and operated upon. The auditors must ensure that these control are sufficient to maintain assets safeguarding, data integrity, system effectiveness and system efficiency and that they are in position and functioning.

Question 16

"Use of Audit Software would increase the probability of detecting frauds". Comment.

(6 marks) (Final May 2008)

Answer

Use of Audit Software: CAATs allow the auditor to give access to data without dependence on the client, test the reliability of client software and perform audit tests more efficiently. CAATs are used to perform various audit procedures like;

(i) Tests of details of transactions and balances e.g. use of audits software to test all or a few transactions in a computer file.

(ii) Analytical review procedures e.g. use of audit software to identify unusual fluctuations or items.

(iii) Compliance tests of IT application controls e.g. use of test data to test the functioning of a programmed procedure.

However, the methods of applying audit procedures to gather evidence may be influenced by the methods of computer processing. Sometimes, in some accounting systems that use of computer for processing significant applications, it may difficult or impossible for an auditor to obtain certain data for inspection, inquiry or confirmation without computer assistance.

CAAT in fraud Detection: In an EDP environment, the Auditor is required to plan his work by exercising reasonable care and skill in such a manner that there is reasonable expectation of detecting material misstatements in the financial information resulting from fraud or error.

Use of the CAAT/ audit software systems will help the auditor to identify errors and frauds in the accounting and internal control system.

Conclusion: Frauds are intentional Auditing through the computer with adequate knowledge of computer systems may highlight some frauds, but there is no empirical evidence to prove the assertion that the use of audit software systems has unearthed well concealed frauds.

Thus, it cannot be conclusively said that use of audit software systems increases the probability of detection of fraud.

7

INVESTIGATION

Question 1

Write a short note on - Audit and Investigation. *(4 marks) (Final May 2001)*

Answer

Audit and Investigation: Audit and investigation differ in objectives and in their nature. Auditing is general while investigation is specific. The object of auditing is to ensure that the financial statements are free and fair not misleading or unreliable. The merit of auditing lies in its ability to pronounce in general terms whether the accounts are basically reliable or not and in accordance with the legal requirements and regulations applicable to the particular audit. Audit is not based on suspicion unless circumstances exist to arouse suspicion of the auditor.

Investigation implies systematic, critical and special examination of the records of a business for a specific purpose. The examination conducted under investigation is intensive as well as exhaustive so far as the activities or areas of accounting is concerned. Investigation requires a concentrated focus on the subject matter of inquiry and related matters. Often, investigations may be spread over a period longer than one year and its scope may extend to inquiry beyond the books of accounts if the circumstances so require.

Question 2

Sri Raghav is above 80 years old and wishes to sell his proprietary business of manufacture of specialty chemicals. C Ltd. wants to buy the business and appoints you to carry out a due diligence audit to decide whether it would be worthwhile to acquire the business.

What procedures you would adopt before you could render any advice to C Ltd.?

(10 marks) (Final May 2002)

Answer

A due diligence audit on behalf of C Ltd. with a view to acquiring the business shall involve following steps:

(1) **Studying Business History:** The principal objective of financial due diligence, is usually to look behind the initial information provided by the entity and to assess the benefits and costs of the proposed acquisition by inquiring into all relevant aspects of the past, present and future of the business to be acquired. The accountants should begin the

financial due diligence review by looking into the history of the entity and the background of the promoters. The details of how the company was set up and who were the original promoters has to be gone into, before verification of financial data in detail. An eye into the history of the target may reveal its turning points, survival strategies adopted by the entity from time to time, the market share enjoyed by the entity and changes therein, product life cycle and adequacy of resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the entity. Broadly, the accountant should make relevant enquiries about the history of business – products, markets, suppliers, expenses and operations.

(2) **Studying the Overall Picture:** It is necessary to see whether the business is engaged in manufacture of one or two important lines of products; whether raw material is available without difficulty; whether products are marketable and have a ready market; whether there is scope for expansion of the market; whether full capacity is being utilised or whether there is scope for utilisation of idle capacity – all those factors are non-financial in nature but an enquiry into them is essential for formulation of a decision to buy or not.

(3) **Economic environment:** The study of the impact of economic forces is important for determining factors that have been responsible for the rise or fall in the sales and profits of the business. At times, political or economic factors also may affect the fortunes of a business; for example, labour distrubances, changes in government policies in the matter of levy of excise and custom duties, imports, etc. It is therefore necessary that the impact of all these factors should be studied and their effect on the business judged on a consideration of the profits in the past.

(4) **Examining Profit and Loss Account:** The Profit and Loss Account for the last few years should be considered – exceptional or non-recurring expenses, incomes should be eliminated to know normal profit and trends in profits. Also to be seen is the trend in sales whether the same is on the increase or decrease after allowing for unusual factors influencing sales. It should be seen whether the business is regular in payment of taxes; both Central and State Taxes; whether taxes are in arrears; whether what arrangement are to be made to clear off the arrears; if taxes and duties are in arrear whether the vendor will undertake to pay the taxes upto the point of sale.

(5) **Examining Net-worth:** The net worth of the business should be ascertained. If the accounts are regularly audited, reliance can be placed on the books; for valuation of tangible assets, the assistance of known expert in the field may be sought; enquiries should be made whether there are unrecorded liabilities of the business; similarly about unrecorded assets. On the basis of net worth of the business, the purchase consideration may be agreed upon.

In addition to the above steps, the following further points have to be seen:

(i) Reason for sale of business and the effect on turnover and profits due to the exist of the present proprietor.

(ii) The length of the lease under which business has been operating.

(iii) The unexpired period of patents if any held by the vendors.

(iv) The age of managerial staff and prospects of their continuing in service in the new environment; the effect of trained managerial staff learning the organisation in production/sales/administrative and the financial liability to pay terminal benefits/compensation, etc.

(v) If bulk sales are to a few limited customers, the profitability should be discounted greatly, because any substantial withdrawal of customers might cause business crashes.

(vi) A company with a sound financial structure can better withstand the stresses and strains of business. A low debt-equity ratio would indicate an ability to grow through debt financing without raising equity.

(vii) The cash generated from operations; the need for redeployment of resources and funds needed for repayment of loans become major factors in determining growth potential.

(viii) The valuation of goodwill if any should be on reasonable basis having regards to all factors mentioned above.

Question 3

An American Company engaged in the business of manufacturing and distribution of industrial gases, is interested in acquiring a listed Indian Company having a market share of more than 65% of the industrial gas business in India, request you to conduct a "Due Diligence" of this Indian Company and submit your Report. As due Diligence Auditor, what key areas you will cover in your review? List out the contents of your Due Diligence Review Report that you will submit to your USA based Client. (16 marks) (Final May 2003)

Answer

Due Diligence – Key Areas: The American company engaged in the business of manufacturing and distribution of industrial gases wishing to acquire a listed Indian company has commissioned the Due Diligence Audit to assess the strengths and weaknesses of this company. It is quite important for the acquirer to assess the proposal from different angles and specifically as per terms of the assignment and also see whether proposed merger would create operational synergies. On the other hand, financial due diligence review would be performed after the commercial valuation. Accordingly, while a preliminary review might be performed during initial stages of the restructuring exercise and may in fact, be performed simultaneously with the commercial evaluation, at a later stage, financial due diligence may be performed on the books of account and other information directly pertaining to the financial matters of the entity. In addition, a legal due diligence may be required where legal aspects of functioning of the entities are reviewed; for example, the legal aspects of property owned by the entity or compliance with various statutory requirements under various laws. Like other due diligence exercises, environmental and personnel due diligence are also carried out in order to establish whether various propositions with regard to environment and personnel of the enterprise under review are appropriate. In any case, it is quite important to look behind the veil of initial information provided by the company and to assess the benefits and costs of the proposed acquisition/merger by inquiring into all relevant aspects of the past, present and future of the business to be acquired. Some of the significant key areas which shall be covered under the review are as under:

(1) Historical Background: The accountant should begin the financial due diligence review by looking into the history of the company and the background of the promoters. The details of how the company was set up and who were the original promoters has to be gone into, before verification of financial data in detail. An eye into the history of the company may reveal its turning points, survival strategies adopted from time to time, the market share enjoyed by and changes therein, product life cycle and adequacy of resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the said company. This could, *inter alia*, include the nature of business(es), location of production facilities, warehouses, offices, products or services and markets.

(2) Significant Accounting Policies: The accounting policies being followed by the company and the appropriateness thereof is another key area. The impact of the recent changes in the accounting policies in the recent past keeping in view its intention of offering itself for sale. The accountant has to look at the main effect of accounting policies on the overall profitability and their correctness. It is also quite important to ascertain significant accounting policies used by the company, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the company are different from those adopted by the acquiring enterprise and the effect of such differences. Finally, examine whether the financial statements of the company have been prepared in accordance with the governing statutory requirements.

(3) Review of Financial Statements: An evaluation of the profit reported by the company would be largely based upon its operating results. Any extraordinary item of income or expense that might have affected the operating results would require close examination. It is advisable to compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period. It is important that the trading results for the past four to five years are compared and the trend of normal operating profit arrived at. The normal operating profits should further be benchmarked against other similar companies. Besides the above, and based on the trend of operating results, the accountant has to advise the acquiring enterprise, through due diligence report, on the indicative valuation of the business. The exercise to evaluate the balance sheet of the company has to take into consideration the basis upon which assets have been valued and liabilities have been recognised. The net worth of the business has to be arrived at by taking into account the impact of over/under valuation of assets and liabilities.

(4) Cash Flow: A review of historical cash flows and their pattern would reflect the cash generating abilities of the company and should highlight the major trends. It is important to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time. It is necessary to check:

(a) Whether the company is able to honour its commitments to its creditors, to the banks, to government and other stakeholders;

(b) How well is the company able to turn its debtors and stocks;

(c) How well does it deploy its funds; and

(d) Whether any funds are lying idle or is the company able to reap maximum benefits out of the available funds.

(5) Financial Projections: The projections for the next five years with detailed assumptions and workings and the appropriateness of assumption used in the preparation and presentation of financial projections. If the accountant is of the opinion that as assumption used by the company are unrealistic, the accountant should consider its impact on the overall valuation of the company.

(6) Human Resources: In the Indian context, the status of work force, staff and employees is a complex problem. It is important to work out how much of the labour force has to be retained. It is also important to judge the job profile of the administrative and managerial staff to gauge which of these match the requirements of the new incumbents. The aspects whether all employee benefits like PF, Gratuity, ESI and superannuation have been properly paid/funded. The pay packages of the key employees will be thoroughly reviewed since this can be a crucial factor in future employee costs.

(7) Statutory Compliance: This is one area that has to be examined in detail. It is important to make a list of laws that are applicable to the entity as well as to make a checklist of compliance required from the company under those laws. If the company has not been regular in its legal compliance, it could lead to punitive charges under the law. The impact on such violations be quantified and assessed in respect of entity; financial status and even on its governing concern status.

Contents of a Due Diligence Report: Briefly, the contents of a due diligence report can be discussed under:

- Terms of reference and scope of verification
- Objective of due diligence
- Brief history of the company including shareholding pattern
- Assessment of management structure
- Assessment of financial liabilities with special emphasis on Interlocking investments and financial obligations with group/associates companies, amounts receivables subject to litigation, any other likely liability which is not provided for in the books of account.
- Assessment of valuation of assets including comments on properties, terms of leases, lien and encumbrances including status of charges, liens, mortgages, assets and properties of the company.
- Assessment of operating results

- Assessment of taxation and statutory liabilities
- Assessment of possible liabilities on account of litigation and legal proceedings against the company and suggestion on ways and means including affidavits, indemnities, to be executed to cover unforeseen and undetected contingent liabilities.
- Assessment of net worth.
- Suggestions on various aspects to be taken care of before and after the proposed merger / acquisition.
- Status of franchises, license and patents.

Finally, an executive summary may be prepared highlighting the significant areas.

Question 4

A nationalised bank received an application from an export company seeking sanction of a term loan to expand the existing sea food processing plant. In this connection, the General Manager, who is in charge of Advances, approaches you to conduct a thorough investigation of this limited company and submit a confidential report based on which he will decide whether to sanction this loan or not.

List out the points you will cover in your investigation before submitting your report to the General manager. *(16 marks) (Final May 2003)*

Answer

Investigation on Behalf of the Bank for Advances: A bank is primarily interested in knowing the purpose for which a loan is required, the sources from which it would be repaid and the security that would be available to it, if the borrower fails to pay back the loan. On these considerations, the investigating accountant, in the course of his enquiry, should attempt to collect information on the undermentioned points:

(i) Purpose for which the loan is required and the manner in which the borrower proposed to invest the amount of the loan.

(ii) Schedule of repayment of loan submitted by the borrower, particularly, the assumptions made therein as regards amounts of profits that will be earned in cash and the amount of cash that would be available for the repayment of loan to confirm that they are reasonable and valid in the circumstances of the case.

(iii) Financial standing and reputation for business integrity enjoyed by the directors and officers of the company.

(iv) Authorisation under Memorandum or the Articles of Association to borrow money for the purpose for which the loan will be used.

(v) History of growth and development of the company and its performance during the past five years.

To investigate the profitability of the business for judging the accuracy of the schedule of repayment furnished by the borrower, as well as the value of the security in the form of assets of the business already possessed and those which will be created out of the loan, the investigating accountant would be concentrating on the following points:

(a) Preparation of a condensed income statement from the Profit and Loss Accounts for the previous five years, showing separately therein various items of income and expenses, the amounts of gross and net profits earned and taxes paid annually during each of the five years. The amount of maintainable profits determined on the basis of foregoing statement should be increased by the amount by which these would increase on the investment of borrowed funds.

(b) Computation of under-mentioned ratios separately and then include them in the statement to show the trend as well as changes that have taken place in the financial position of the company:

  (i) Sales to Average Stocks held.

  (ii) Sales to Fixed Assets.

  (iii) Equity to Fixed Assets.

  (iv) Current Assets to Current Liabilities.

  (v) Quick Assets (the current assets that are readily realisable) to Quick Liabilities.

  (vi) Equity to Long Term Loans.

  (vii) Sales to Book Debts.

  (viii) Return on Capital Employed.

(c) Break-up of annual sales product-wise to show their trend.

(d) Schedule of assets and liabilities of the borrower including the particulars stated below:

  (i) ***Fixed assets***: A full description of each item, its gross value, the rate at which depreciation has been charged and the total depreciation written off. In case the rate at which depreciation has been adjusted is inadequate, the fact should be stated. In case any asset is encumbered, the amount of the charge and its nature should be disclosed. In case an asset has been revalued recently, the amount by which the value of the asset has been decreased or increased on revaluation should be stated along with the date of revaluation. If considered necessary, he may also comment on the revaluation and its basis.

  (ii) ***Stocks**:* The value of different types of stocks held (raw materials, work-in-progress and finished goods) and the basis on which these have been valued. Details as regards the nature and composition of finished goods should be disclosed. Slow-moving or obsolete items should be separately stated along with the amounts of allowances, if any, made in their valuation. For assessing redundancy, the changes that have occurred in important items of stock subsequent to the date of the Balance Sheet, either due to conversion into finished goods or sale, should be considered. If any stock has been pledged as a security for a loan the amount of loan should be disclosed.

(iii) ***Sundry debtors, including bills receivable****:* Their composition should be disclosed to indicate the nature of different types of debts that are outstanding for recovery; also whether the debts were being collected within the period of credit as well as the fact whether any debts are considered bad or doubtful and the provision if any, that has been made against them. Further, the total amount outstanding at the close of the period should be segregated as time-period wise.

(iv) ***Investments*** *:* The schedule of investments should be prepared. It should disclose the date of purchase, cost and the nominal and market value of each investment. If any investment is pledged as security for a loan, full particulars of the loan should be given.

(v) ***Secured Loans****:* Debentures and other loans should be included together in a separate schedule. Against the debentures and each secured loan, the amounts outstanding for payments along with due dates of payment should be shown. In case any debentures have been issued as a collateral security, the fact should be stated. Particulars of assets pledged or those on which a charge has been created for re-payment of a liability should be disclosed.

(vi) ***Provision of Taxation****:* The previous years up to which taxes have been assessed should be ascertain. If provision for taxes not assessed appears in be inadequate, the fact should be stated along with the extent of the shortfall.

(vii) ***Other Liabilities****:* It should be stated whether all the liabilities, actual and contingent, are correctly disclosed. Also, an analysis according to ages of trade creditors should be given to show that the company has been meeting its obligations in time and has not been depending on trade credit for its working capital requirements.

(viii) ***Insurance****:* A schedule of insurance policies giving details of risks covered, the date of payment of last premiums and their value should be attached as an annexure to the statements of assets, together with a report as to whether or not the insurance-cover appears to be adequate, having regard to the value of assets.

(ix) ***Contingent Liabilities****:* By making direct enquiries from the borrower company, from members of its staff, perusal of the files of parties to whom any loan has been advanced those of machinery suppliers and the legal adviser, for example, the investigating accountant should ascertain particulars of any contingent liabilities which have not been disclosed. In case, there are any, these should be included in a schedule and attached to the report.

(x) The impact on economic position of the company by economic, political and social changes that are likely to take place during the period of loan.

Question 5

You are the internal auditor of AB Manufacturing Co. Ltd. The Managing Director has asked you to enquire into the causes of abnormal wastage of raw materials during the month of September, 2003.

The wastage percentages are as follows:

June, 2003	*1.2%*
July, 2003	*1.1%*
August, 2003	*1.3%*
September, 2003	*3.6%*

How will you proceed to carry out the Assignment? *(8 marks) (Final Nov 2003)*

Answer

Abnormal Wastage of Raw Material: The rate of wastage in September, 2003 has risen sharply as compared to previous months. Under the circumstances, before setting for detailed investigation, the internal auditor need to understand the manufacturing environment right from the stage of purchase of materials, the movement of stock flow through the production process while its becomes finished goods. To locate the reasons for the abnormal wastage, the internal auditor should first of all assess the general requirements as under:

(i) Procure a list of raw materials, showing the names and detailed characteristics of each raw material.

(ii) Obtain the standard consumption figures, and ascertain the basis according to which normal wastage figures have been worked out. Examine the break up of a normal wastage into that in process, storage and handling stages. Also obtain control reports, if any, in respect of manufacturing costs with reference to predetermined standards.

(iii) Examine the various records maintained for recording separately the various lots purchased and identification of each lot with actual material consumption and for ascertaining actual wastage figures therein.

(iv) Obtain reports of Preventive Maintenance Programme of machinery to ensure that the quality of goods manufacture is not of sub-standard nature or leads to high scrappage work.

(v) Assess whether personnel employed are properly trained and working efficiently.

(vi) See whether quality control techniques have been consistent or have undergone any change.

(vii) Examine inventory plans and procedures in report of transportation storage efficiency, deterioration, pilferage and whether the same are audited regularly.

(viii) Examine whether the basis adopted for calculating wastage for September is the same as was adopted for the other three months.

(ix) Obtain a statement showing break up of wastage figures in storage, handling and process for the four months under reference and compare the results of the analysis for each of the four months.

Some specific reasons for abnormal wastage in process specific may be considered by the auditor are as under:

(a) Examine laboratory reports and inspection reports to find out if raw materials purchased were of a poor quality or were of sub-standard quality. This will be most useful if it is possible to identify the wastage out of each lot that has been purchased.

(b) Machine breakdown, power failure, etc. may also result into loss of materials in process. Check the machine utilisation statements.

(c) A high rate of rejections in the finished lots may also be responsible for abnormal wastage; therefore, examine the inspectors' reports in respect of inspection carried out on the completion of each stage of work or process.

(d) It is possible that the wastage may have occurred because the particular lot out of which issues were made in September, 2003 was lying in the store for a long time, leading to deterioration in quality or because of a change in the weather which may have led to the deterioration. Compare the wastage figures of September, 2002 with those of September, 2003.

(e) Abnormal wastage in storage and handling may arise due to the following reasons:

  (i) *Write offs on account of reconciliation of physical and book stocks*: In case of periodical physical stock taking, such write offs will be reflected only in the month such reconciliation takes place.

  (ii) *Accidental, theft or fire losses in storage*: The auditor should examine the possibility of these for the purpose.

(f) Examine whether any new production line was taken up during the month in respect of which standard input-output ratio is yet to be set-up.

Question 6

What are the important steps involved while conducting Investigation on behalf of an Incoming Partner? (8 marks) (Final Nov 2003)

Answer

Steps involved while conducting investigation on behalf of an incoming partner: The general approach of the investigating accountant in this type of investigation would be more or less similar, irrespective of the nature of business of the firm-manufacturing, trading or rendering a service. Primarily, an incoming partner would be interested to know whether the terms offered to him are reasonable having regard to the nature of the business, profit records, capital distribution, personal capability of existing partners, socio-economic setting, etc. and whether he would be capable for services to be rendered, which can be justified by the overall economic conditions prevailing and other considerations considering his own personality and achievements. In addition, he would be interested to ascertain whether the capital to be contributed by him would be safe and applied usefully. Broadly, the steps involved are as under :

(a) Ascertaining the history of the firm since inception and growth of the firm.

(b) Studies of the provisions of the Deed of Partnership, particularly for composition of partners, their capital contribution, drawing rights, retirement benefits, job allocation, etc.

(c) Scrutiny of the record of profitability of the firm's business over a suitable number of years, with usual adjustments that are necessary in ascertaining the true record of business profits. Particular attention should, however, be paid to the nature and profitability of the business, qualification and expertise of the partners and such others as may be relevant.

(d) Examination of the asset and liability position to determine the tangible asset, partners, investment, appraisal of the value of intangibles like goodwill, know-how, patents, etc impending liabilities including contingent liabilities and those for pending tax assessment.

(e) Assess position of order at hand and the range and quality of clientele should be thoroughly examined under which the firm is presently operating.

(f) Scrutinise terms of loan finance to assess its usefulness and the implication for the overall financial position.

(g) Study important contractual and legal obligations should be ascertained and their nature studied. It may be the case that the firm has standing agreement with the employees as regards salary and wages, bonus, gratuity and other incidental benefits. Full import of such standing agreements would be gauged before a final decision is reached.

(h) Study the composition and quality of key personnel employed by the firm and any likelihood of their leaning the organisation.

(i) Ascertain reasons for the offer of admission to a new partner and it should be determined whether the same synchronizes with the retirement of any senior partner whose association may have had considerable impact having on the firm's successes.

(j) Appraisal of the record of capital employed and the rate of returns. It is necessary to have a comparison with alternative business avenues for investments and evaluation of possible results on a changed capital and organisation structure.

(k) Ascertain manner of computation of goodwill on admission as also on retirement, if any.

(l) Examine whether any special clause exist in the Deed of Partnership to allow admission in future a new partner.

Question 7

Mr. Clean who proposes to buy the proprietary business of Mr. Perfect, engages you as investigating accountant. Specify the areas which you will cover in your investigation.

(8 marks) (Final May 2004)

Answer

Areas to be covered in the investigation: The first and foremost important aspect in any business investigation is to have an overall picture of the position of the business which is being investigated before the details are gone into. Further, it is important to know whether the business is engaged in the manufacture of one or two important lines of products, is principally processing materials or is concerned only with the sale of a single product. Also, whether it is a business which depends for its success on imported raw materials or supply of parts and components from ancillary businesses or uses indigenous materials and parts which are manufactured locally. If the business is labour - intensive, its future profitability would be dependent on availability of skilled labour and relations of the management with the trade unions. Labour relations thus can affect the future profitability of the business. The method of distribution of products, either through wholesalers or retailers also must be examined. For studying the economic and financial position of the business, the following should be considered:

(i) The adequacy or otherwise of fixed and working capital. Are these sufficient for the growth of the business?

(ii) What will be the trend of the sales and profits in the future? The success of a business in the future would depend on the position enjoyed by it in the past in relation to its competitors. A business may be successful because it enjoys a monopoly. In such a case, the possibility of emergence of competition must be examined. This may be ascertained on the basis of the trend in market share of the product and the licensing policy followed by the government. Establishing the trend of sales, product-wise and area-wise will ordinarily help in drawing a conclusion on whether the trend will be maintained in the future.

(iii) Whether the profit which the business could be expected to maintain in the future would yield an adequate return on the capital employed?

From the accountant's view point, the following specific areas need to be looked into:

Profit and Loss Account: To study the Profit and Loss Account of a concern and consider each item, included therein, in relation to the corresponding items in the Profit and Loss Account of the previous years. It is therefore, necessary that a summary, in a columnar form, should be prepared of the balances included in the Profit and Loss Accounts of the business for a period, say of 5 to 7 years.

Fixed Assets: Fixed assets, usually, are shown in accounts at cost less depreciation but the accounts do not show the ages of different assets. It is desirable, therefore, to obtain age analysis of various items of fixed assets. Assets which are old or are obsolete would naturally have to be replaced. It should be seen that their values are not in excess of the value of service that they could be expected to render to the business during the balance period of their active life and the amount they would fetch on sale as scrap.

Stock and work-in-progress: It should be seen that stocks have been valued consistently and that the basis of valuation was such that the value placed on stocks did not include any element of profit. Also, there should be due allowance for damaged, obsolete and slow moving stocks.

Other liquid assets: It should be ascertained that the assets so described are readily realisable. Money with a bank in liquidation should be taken only to the extent guaranteed by Deposit Insurance Scheme.

Idle assets: On a scrutiny, it may appear that certain assets are remaining idle and are not being properly applied in the business. For example, certain plant and machinery may have been put to use after a considerable period of time after acquisition. Some of the fixed assets may be awaiting installation even at the valuation time.

Liabilities: The important matter to investigate in this regard is whether those are stated fully or understated or overstated. In other words, whether the profits of the business have been inflated by suppression of liabilities or there are any free reserves included in the liabilities. In either case, an adjustment would be necessary. Secondly, it should be ascertained that liabilities are not unduly 'large or are not outstanding for a long time, in such cases, it would be necessary to pay off some of them which would cause a drain on the liquid resources of the concern. The fact should be stated in the report.

Taxation: Orders in respect of assessments completed should be studied and it should be verified that an adequate provision has been made in respect of liabilities for taxes which have not been assessed. Also, it should be seen that in the past there has been no reopening of assessments. If so, the company may be liable for an undisclosed sum of taxes plus penalties. Any temporary tax benefit should also be disregarded.

Apart from the above areas, the other factors relating to the management, skilled labour, etc. may also be covered in the investigation.

Question 8

Write a short note on - Audit vs. Investigation. *(4 marks) (Final Nov 2004)*

Answer

Audit vs. Investigation: Etymologically, auditing and investigation are largely overlapping concepts because auditing is nothing but an investigation used in a broad sense. Both auditing and investigation are fact finding techniques but their basic nature and objectives differ as regards scope, frequency, basis, thrust, depth and conclusiveness. Audit and investigation differ in objectives and in their nature. Auditing is general while investigation is specific. The object of auditing is to ensure that the financial statements are free and fair and not misleading or unreliable. The merit of auditing lies in its ability to pronounce in general terms whether the accounts are basically reliable or not and in accordance with the legal requirements and regulations applicable to the particular audit. Audit is not based on suspicion unless circumstances exist to arouse suspicion of the auditor.

Investigation implies systematic, critical and special examination of the records of a business for a specific purpose. The examination conducted under investigation is intensive as well as exhaustive so far as the activities or areas of accounting is concerned. Investigation requires a concentrated focus on the subject matter of inquiry and related matters. Often, investigations may spread over a period longer than one year and its scope may extend to inquiry beyond the books of accounts if the circumstances so require.

Question 9

Your client is contemplating taking over a manufacturing concern and desires that in the course of due diligence review, you should look specifically for any hidden liabilities and overvalued assets.

State (in brief) the major areas you would examine for the above. (8 marks)(Final Nov 2005)

Answer

Due diligence is an all pervasive exercise to review all important aspects like financial, legal, commercial, etc. before taking any final decision in the matter. As far as any hidden liabilities or overvalued assets are concerned, this shall form part of such a review. Normally, cases of hidden liabilities and overvalued assets are not apparent from books of accounts and financial statements. Review of financial statements does involve examination from the view point of extraordinary items, analysis of significant deviations, etc. However, in order to investigate hidden liabilities, the auditor should pay his attention to the following areas:

- Any show cause notice, which have not matured into demands but may be material and important.
- Contingent liabilities not shown in books
- Letters of comforts given to banks and financial institutions
- Company may have sold some subsidiaries / businesses and may have agreed to take over and indemnify all liabilities and contingent liabilities of the same prior to the date of transfer.
- Product and warranty liabilities, product returns & discounts, liquidated damages, etc.
- Tax liability under direct and indirect taxes.
- Long pending sales tax assessment.
- Cases of custom duty where only provisional assessment has been made and final assessment is yet to completed.
- Agreement to buy back shares at a stated price.
- Future lease liabilities.
- Claims against the company including third party claims.
- Unfunded retirement benefit of employees.

- Labour claims under negotiations.

Regularly Overvalued assets: The auditor shall have to specifically examine the following areas:

- Uncollectable receivables.
- Obsolete, slow and non-moving inventories and inventories valued above net realizable value, if any.
- Obsolete and unused plant and machinery and their spares.
- Assets value which have impaired due to sudden fall in market value.
- Assets shown in books above market value due to capitalization of expenditure / foreign exchange fluctuation or capitalisation of revenue expenditure.
- Assets under litigation.
- Investment shown at cost whose market value is much lower.
- Investment carrying very low rate of return.
- Infructuous project expenditure.
- Intangibles of no value.

Question 10

A company engaged in manufacturing of chemicals is consistently recording higher sales turnover, but declining net profits since the last 5 years. As an investigator appointed to find out the reasons for the same, what are the points you would verify? (8 marks)(Final May 2006)

Answer

Decline in Net Profits Despite Increasing Sales: As per the facts that there has been consistently high turnover but declining net profits is an anomalous situation. It may be attributed to one or more following reasons requiring further investigation:

(i) ***Unfavourable Sales mix***: Where the company sells different chemical products with different product margins, the product with the maximum PV ratio/margin should have a higher share in the total sales. If due to revision of sales mix, more quantities of unprofitable products are sold, profits will be reduced in spite of an increase in sales.

(ii) ***Negative Impact of Financial Leverage***: Where the company does not have sufficient own funds (equity) but has a higher debt-equity ratio, the interest commitments will be higher. As the volume of its operation increases, higher debt and interest charges would result in lower profits.

(iii) ***Other Items Included in Sales***: The figure of sales as per Profit and Loss Account may include incidental revenues, e.g., freight, excise duty, sales-tax, etc. where the amount of excise duty goes up considerably the total sales may show an increase which is not represented by a real increase in sales quantity/value.

(iv) ***High Administrative and Selling Expenses***: Administrative and selling costs are generally period costs which are fixed in nature. Their increase is generally not proportional to sale increase. However, a reduction in profit could also be due to increase in administrative overheads and sales overheads at a rate higher than the rate of increase in sales.

(v) ***Cost-Price Relationship***: If the increases in cost of raw materials and labour has not been compensated by a corresponding increase in the sales price this would also result in higher sales and declining profits. In spite of same sales quantity, for the increasing cost of raw materials and other services, per unit values of the product has been increased which is however unmatched by the increase in cost.

(vi) ***Competitive Price***: Where sales have been made at cut-throat prices in order to eliminate competition from the market, the profits would be in the declining trend in the short-run.

(vii) ***Additions to Fixed Assets***: Where there are heavy additions to fixed assets and consequent depreciation charges in the initial years of additions, there may be reduction in profits in spite of increased sales.

Question 11

Write a short note on - Outline the contents of a due diligence report.

(8 marks) (Final May 2007)

Answer

Contents of a Due Diligence Report : The Contents of a due diligence report vary with individual cases but the following can be illustrative headings:

(i) Executive summary.

(ii) Introduction.

(iii) Background of target.

(iv) Objective of due diligence.

(v) Terms of reference and scope of verification.

(vi) Brief history of the company.

(vii) Summary on capital structure and group structure of company.

(viii) Shareholding pattern.

(ix) Observations on the review.

(x) Assessment of Management structure.

(xi) Assessment of financial liabilities.

(xii) Assessment of valuation of assets.

(xiii) Comments on properties, terms of leases, lien and encumbrances.

(xiv) Assessment of operating results.

(xv) Assessment of taxation and statutory liabilities.

(xvi) Assessment of possible liabilities on account of litigation.

(xvii) Assessment of net worth.

(xviii) Any liabilities not provided for in the books.

(xix) SWOT analysis comments on future projections.

(xx) Status on charges, liens, mortgages and assets of the company.

(xxi) Ways and means to cover unforeseen contingent liabilities.

(xxii) Aspects to be taken care of before/after merger.

(xxiii) Interlocking investments and financial obligations with group/associate companies amounts receivable subject to litigation.

Question 12

In a Company, it is suspected that there has been an embezzlement in cash receipts. As an investigator, what are the areas that you would verify? (8 marks) (Final Nov 2007)

Answer

The following areas need to be verified in this regard:

(i) Issuing a receipt for full amount collected, entering only a lesser amount on the counterfoil.

(ii) Showing a larger cash discount than actually allowed.

(iii) Adjusting a fictitious credit in the account of a customer for goods returned.

(iv) Cash sales entered as credit sales with debit to customer.

(v) Writing off a good debt as bad and irrecoverable to cover up misappropriation of amount collected.

(vi) Short-debiting customer's ledger account and withdrawing the difference on collection of full amount.

(vii) Under-casting the receipts side of cash book; carrying over a shorter total of the receipts from one page of the cash book to the next so as to cover up short banking misappropriated.

(viii) Over-casting the payment side of the cash book; over-carrying the total of the payments from one page of the cash book to the next so as to cover up misappropriation of a part of the amount withdrawn from the bank.

Question 13

What are the areas in which Due Diligence can take place ? (5 marks) (Final May 2008)

Answer

Areas in which Due Diligence can take place

1. **Commercial/operational due diligence**: It is generally performed by the concerned acquire enterprise involving an evaluation from commercial, strategic and operational perspectives. For example, whether proposed merger would create operational synergies.
2. **Financial Due Diligence**: It involves analysis of the books of accounts and other information pertaining to financial matters of the entity. It should be performed after completion of commercial due diligence.
3. **Tax Due diligence**: It is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence .The accountant has to look at the tax affect of the merger or acquisition.
4. **Information systems due diligence**: It pertains to all computer systems and related matter of the entity.
5. **Legal due diligence**: This may be required where legal aspects of functioning of the entity are reviewed. For example, the legal aspects of property owned by the entity or compliance with various statutory requirements under various laws.
6. **Environmental due diligence**: It is carried out in order to study the entity's environment, its flexibility and adaptiveness to the acquirer entity.
7. **Personnel due diligence**: It is carried out to ascertain that the entity's personnel policies are in line or can be changed to suit the requirements of the restructuring.

8

COST AUDIT

Question 1

Write a short note on - True and Fair Cost of Production. *(4 marks)(Final May 2001)*

Answer

True and Fair Cost of Production: A cost auditor checks the cost accounting records to verify that the cost statements are properly drawn up as per the records and that they present a true and fair view of the cost of production and marketing of various products dealt with by the undertaking. The Cost Audit (Report) Rules, 1996 prescribe the rules regarding the cost audit report. The prescribed format of the report contains assertions regarding whether cost accounting records have been properly kept so as to give a true and fair view of the cost of production/ processing/ manufacturing/ mining activities and marketing of the product under reference. It may be noted that unlike in the case of audit of financial statements, the cost auditor does not have to state whether the cost statements reflect a true and fair view. In any case, the true and fair concept is known to us in the context of financial accounts. Based on that knowledge, it may be assumed that the following are the relevant considerations in determining whether the cost of production determined is true and fair:

(a) Determination of cost following the generally accepted cost accounting principles.

(b) Application of the costing system appropriate to the product.

(c) Materiality.

(d) Consistency in the application of costing system and cost accounting principles.

(e) Maintenance of cost records and preparation of cost statements in the prescribed form and having the prescribed contents.

(f) Elimination of material prior-period adjustments.

(g) Abnormal wastes and losses and other unusual transactions being ignored in determination of cost.

Question 2

For what purposes the Cost Auditor refers to financial records while conducting Cost Audit of an entity? *(8 marks) (Final May 2002)*

Answer

A cost auditor is ultimately required to express an opinion as to whether the company has maintained proper cost accounting records so as to give a true and fair view of cost of production, etc. In arriving at this opinion, the cost auditor is required to ascertain about multitude of information such as cost of raw materials consumed, cost of power, cost of stock, employer costs, provision for depreciation, royalty and technical payment, abnormal cost, scrap, fuel etc. Annexure to the cost audit reports require detailed information in respect of financial position including capital employed, net worth, profit, net rates, operating profit, unit cost of power and fuel, total wages and salaries, etc. It is obvious therefore that cost audit cannot be done without reference to financial books, more so in the context of the statutory requirement to have a statement of reconciliation with financial accounts as part of cost audit report. Further the cost statements also contain a summary of all expenditure incurred by the company and the share in such expenditure attributable to the activities covered by Cost Accounting Records Rules; Overhead expenditure also needs allocation between activities covered by rules and activities not so covered. Naturally this can be done only with reference to financial ledger. Under Part II of Schedule VI to the Companies Act, 1956, quite a few matters which are to be mentioned in the Profit and Loss Account of the company are also to be covered in cost statements such as consumption of raw materials in quantity and value, sale of finished goods under classified headings in quantity and nature, actual production quantity of value, inventory in quantity of value for each class of goods, etc. A correlation between consumption of raw materials as per cost records and financial records may throw up the need for inquiry into errors, mistakes and manipulation. Material discrepancy between financial records and cost records will be highlighted in the reconciliation statement which would required that the cost auditor may examine deviation before reporting on the same. Thus it is imperative for the cost auditor to refer to financial records for conducting the cost audit.

Question 3

What is meant by True and Fair Cost of Production? *(6 marks) (Final Nov 2002)*

Answer

True and Fair Cost of Production: The concept of "True and Fair Cost of Production" is used in the context of cost audit wherein the cost auditor has to state whether in his opinion the company's cost accounting records have been kept so as to give a true and fair view of the cost of production, processing and marketing of the product. A cost auditor checks the cost accounting records to verify that the cost statements are properly drawn up as per the records and that they present a true and fair view of the cost of production and marketing of various products dealt with by the undertaking. The following are the relevant considerations in determining whether the cost of production determined by the cost auditor is true and fair:

- Determination of cost following the generally accepted cost accounting principles
- Application of the costing system appropriate to the product
- Materiality

- Consistency in the application of costing system and cost accounting principles
- Maintenance of cost records and preparation of cost statements in the prescribed form and having the prescribed contents
- Elimination of material prior-period adjustments
- Abnormal wastage's and losses and other unusual transactions being ignored in determination of cost.

It as a result of the examination of the books of account, the cost auditor desires to give a qualified report he shall indicate the extent to which he has to qualify the report and the reasons therefor.

Question 4

Write a short note on - Reconciliation of cost and financial accounts.

(4 marks) (Final May 2003)

Answer

Reconciliation of Cost and Financial Accounts: A cost auditor is ultimately required to express an opinion as to whether the company has maintained proper cost accounting records so as to give a true and fair view of cost of production etc. In arriving at this opinion, the cost auditor is required to ascertain about multitude of information such as cost of raw materials consumed, cost of power and scrap fuel cost of stock, employer costs, provision for depreciation, royalty and technical payment, abnormal cost, etc. Annexure to the cost audit reports requires detailed information in respect of financial position including capital employed, net worth, profit, net rates, operating profit, unit cost of power and fuel, total wages and salaries etc. It is obvious therefore that cost audit cannot be done without reference to financial books, more so in the context of the statutory requirement to have a statement of reconciliation with financial accounts as part of cost audit report. Further the cost statements are to contain a summary of all expenditure incurred by the company and the share in such expenditure attributable to the activities covered by Cost Accounting Records Rules; Overhead expenditure also needs allocation between activities covered by rules and activities not so covered. Naturally this can be done only with reference to financial ledger. Under Part II of Schedule VI to the Companies Act, 1956, quite a few matters which are to be mentioned in the Profit and Loss Account of the company are also to be covered in cost statements such as consumption of raw materials in quantity and value, sale of finished goods under classified headings in quantity and nature, actual production quantity of value, inventory in quantity of value for each class of goods, etc. A correlation between consumption of raw materials as per cost records and financial records may through up the need for inquiry into errors, mistakes and manipulation. Material discrepancy between financial records and cost records will be highlighted in the reconciliation statement which would required that the cost auditor may examine deviation before reporting on the same. Thus it is imperative for the cost auditor to refer to financial records.

Question 5

Write a short note on - Advantages of Cost Audit to Government. (4 marks) (Final Nov 2004)

Answer

Advantages of Cost Audit to Government: Cost auditor's approach is to ensure that the cost accounting plan is in consonance with the objectives set by the organisation and the system of accounting is geared towards the attainment of the objectives. A cost accounting system designed to exercise control over cost may be different from the one if the objective is to fix price. Accordingly, over a period of time particularly in view of administered pricing system the cost accounting becomes quite important. Some of the specific advantages which can be reaped by the Government are:

(i) It helps in the fixation of selling prices of essential commodities and thereby avoiding undue profiteering.

(ii) In the case of cost plus contracts of Government, it helps to fix the price at reasonable level.

(iii) It enables the Government to focus the attention on inefficient units.

(iv) It enables the Government to lay down policies in favour of protecting certain industries.

(v) It facilitates the settlement of disputes brought to the Government.

(vi) It creates healthy competition in the industry.

Question 6

"Like every other audit, a systematic planning for cost audit is also necessary". Indicate the matters to be included in a Cost Audit Programme. (10 marks)(Final Nov 2005)

Answer

Matters to be included in Cost Audit Programme: It is a true statement that like any other audit a systematic planning for cost audit is also necessary. Therefore, the cost audit programme should include all the usual broad steps that a financial auditor includes in his audit programme. This would require that the various aspects like what to be done, when to be done and by whom to be done are adequately takes care of. However, looking to the basic difference in cost audit and financial audit as allocation and apportionment of expenses, statutory requirement etc. should require special consideration. Cost audit, in order to be effective, should be completed at one time as far as practicable. Based on above factors a set of procedures and instructions are evolved which may be termed the cost audit programme. Matters to be included in the Cost Audit Programme may be divided into following two stages:

(i) Review of Cost accounting record: This will include:

- Method of costing in use
- Method of accounting for raw material, stores and spares, wastage
- System of recording wages, salary, etc.
- Basic of allocation of overheads to cost centres and absorption by product and services

- Treatment of expenses on finance, R&D, royalty, etc.
- Method for depreciation accounting
- Method of stocktaking and valuation
- System of budgetary control

(ii) Verification of cost statement and other data: This will mainly cover:

- Licensed, installed and utilized capacity
- Operating and financial ratio
- Production data
- Consumption of material and actual expenses
- Sales realization
- Abnormal non-recurring and special cost
- Reconciliation with financial books

Some other factors which need to be brought into cost audit programme includes system of cost accounting, range of products, areas to be covered etc. indicating allocation of manpower and the time to be taken for computing the audit.

Question 7

What are the advantages that accrue to the stockholders of a company because of a Cost audit?

(8 marks) (Final May 2007)

Answer

Stages of Cost Audit : Cost Audit will be advantageous to the stockholders in the following manner :

(1) To Management

(i) Reliability of data for price fixing, control and decision making.

(ii) Waste control and consequently cost reduction.

(iii) Through the system of budgetary control and standard costing, cost control is established.

(iv) Proper valuation of closing stock, work in progress.

(2) To Society

(i) Cost Audit is often introduced for the purpose of price fixation. Customers are saved from exploitation through proper costing of products and services.

(ii) Since price increase by some industries is not allowed without proper justification as to increase in cost of production, inflation through price hikes can be controlled and consumers can maintain their standard of living.

(3) To Shareholders Cost Audit ensures that proper records are kept as to purchases and utilization of materials and expenses incurred on wages etc. It also makes sure that the valuation of closing stock and work-in-progress is on a fair basis. The shareholders are assured about the calculation of the profitability and thus return on their investments.

(4) To Government

(i) In a cost plus contract, price fixation is properly calculated.

(ii) Price ceiling for essential commodities and thus undue profiteering is checked.

(iii) Able to monitor inefficient units

(iv) Decision support on Government protection to certain industries.

(v) Settlement of trade disputes.

Cost audit and consequent management action can create a healthy competition among the various units in an Industry. This imposes an automatic check on inflation.

Question 8

Write a short note on - Normal Capacity for the purpose of Inventory valuation.

(4 marks) (Final May 2008)

Answer

Normal capacity for inventory valuation: As per AS 2, allocations of fixed production overheads for the purpose of there inclusion in the costs of conversion is based on the normal capacity of the production facilities.

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

9

AUDIT OF PUBLIC SECTOR UNDERTAKINGS

Question 1

What are the principles involved regarding "Propriety audit' in the case of Public Sector Undertaking? *(8 Marks) (Final Nov 2000)*

Answer

Section 619 of the Companies Act, 1956 lays down special provisions regarding audit of accounts of public sector undertakings registered as Government Companies. Section 619(4) of the Companies Act, 1956 empowers C&AG to conduct supplementary or test audit. Audit of public enterprises in India is not restricted to financial and compliance audit; it extends also to efficiency, economy and effectiveness with which these operate and fulfil their objectives and goals. Another aspect of audit relates to questions of propriety; this audit is directed towards an examination of management decisions in sales, purchases, contracts, etc. to see whether these have been taken in the best interests of the undertaking and conform to accepted principles of financial propriety. Propriety audit stands for verification of transactions on the tests of public interest, commonly accepted customs and standards of conduct. On an analysis, these tests boil down to tests of economy, efficiency and faithfulness. Instead of too much dependence on documents, vouchers and evidence, it shifts the emphasis to the substance of transactions and looks into the appropriateness thereof on a consideration of financial prudence, public interest and prevention of wasteful expenditure. Thus, propriety audit is concerned with scrutiny of executive actions and decisions bearing on financial and profit and loss situation of the company, with special regard to public interest and commonly accepted customs and standards of conduct. It is also seen whether every officer has exercised the same vigilance in respect of expenditure incurred from public money, as a person of ordinary prudence would exercise in respect of expenditure of his own money under similar circumstances. Some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

(i) The expenditure should not be *prima facie* more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.

(ii) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

(iii) Public moneys should not be utilised for the benefit of a particular person or section of the community unless:

(a) the amount of expenditure involved is insignificant; or

(b) the expenditure is in pursuance of a recognised policy or custom; and

(c) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

It may be stated that it is the responsibility of the executive departments to enforce economy in public expenditure. The aim of propriety audit is to bring to the notice of the proper authorities of wastefulness in public administration and cases of improper; avoidable and in fructuous expenditure.

Question 2

Write a short note on - Propriety Audit. *(4 Marks) (Final May 2001)*

Propriety Audit: Propriety Audit stands for verification of transactions on the tests of public interest commonly accepted customs and standards of conduct. E.L. Kohler has defined the term propriety as "that which meets the tests of public interest, commonly accepted customs and standards of conduct, and particularly as applied to professional performance, requirements of law, government regulations and professional codes". Instead of too much dependence on documents, vouchers and evidence, it shifts the emphasis to the substance of the transactions and looks into the appropriateness thereof on a consideration of financial prudence, public interest and prevention of wasteful expenditure. Thus propriety audit is concerned with scrutiny of executive actions and decisions bearing on financial and profit and loss situation of the company with special regard to public interest and commonly accepted customs, and standards of conduct. It is also seen whether every offer has exercised the same vigilance in respect of expenditure incurred from public money, as a person of ordinary prudence would exercise in respect of expenditure of his own money under similar circumstances. Propriety requires the transactions, and more particularly expenditure, to conform to certain general principles. These principles are:

(i) that the expenditure is not *prima facie* more than the occasion demands and that every official exercises the same degree of vigilance in respect of expenditure as a person of ordinary prudence would exercise in respect of his own money;

(ii) that the authority exercises its power of sanctioning expenditure to pass an order which will not directly or indirectly accrue to its own advantage;

(iii) that funds are not utilised for the benefit of a particular person or group of persons and

(iv) that, apart from the agreed remuneration or reward, no other avenue is kept open to indirectly benefit the management personnel, employees and others.

The Parliament and Government, with a view to knowing the standards of efficiency, propriety, cost consciousness and economy, have already come up with some provisions in the Companies Act, 1956 having direct or indirect bearing on propriety; some of these provisions are:

(i) Section 209(1) (d) relating to Cost Accounting Records.

(ii) Section 227(1A) requiring enquiry into certain specified matters.

(iii) Section 227(4A) requiring a supplementary statement on matters specified in the Manufacturing and Other Companies (Auditor's) Report Order.

(iv) Section 233B - requirement of Cost Audit.

(v) Section 619(3)(a) requiring a supplementary statement in respect of the Government Companies on matters specified.

(vi) Additional information in Schedule VI, Part II.

Problems in propriety audit, however, arise mainly because of its distinct nature. The expression "propriety" is a moral term and can be understood by reference to the concept of morality accepted by the society at a given time. In any auditing, the essential test lies in formulation of auditing propositions. In the audit of financial accounts by reference to financial and legal requirements, propositions are built up about happening of events, existence, accuracy, title, ownership, compliance with law and internal regulations, etc., which are all verifiable. Propriety audit has an inherent element of subjectivity because it is very difficult to establish standards of public interest, commonly accepted customs, standards for conduct which are not firm basis for audit evaluation. To take care of this situation, the C&AG has developed the norms of propriety for expenditure of public funds in our country and this has been discussed in the study above. By laying down the standards of propriety for Government expenditure the C&AG has really tried to tackle in a practical way the complex problem of subjectivity inherent in a situation calling for propriety consideration. The element of subjectivity has caused proper discharge of duty very delicate and demands discretion, but wisdom of taking commercial decisions under dynamic environment (the economic, social and political) must be evaluated with reference to the circumstances in which these were taken and therefore, the auditor in his field must reconstruct such circumstances. The judgement of the auditor must be objective as otherwise it would dampen the initiative of management and others in taking commercial decisions and propriety audit would prove itself to be counter productive.

Question 3

What is a comprehensive audit of public enterprises? Discuss some of the areas to be examined therein. *(8 Marks) (Final Nov 2001)*

Answer

Comprehensive Audit of Public Enterprises : Areas to be examined: The scope and extent of audit of public sector enterprises is determined by the Comptroller and Auditor General of India. Audit of public enterprises in India is not restricted to financial and compliance audit; it extends also to efficiency, economy and effectiveness with which these operate and fulfil their objectives and goals. Another aspect of such audit relates to questions of propriety; this audit is directed towards an examination of management decisions in sales, purchases, contracts, etc. to see whether these have been taken in the best interests of the undertaking and conform to accepted principles of financial propriety. Comprehensive audit involves assessing efficiency and effectiveness of public enterprises in its entirety to be conducted on the basis of certain standards and criterion. Public enterprises have been set-up with socio-objectives. An objective assessment with reference to such objectives' fulfillment would require comprehensive audit.

The starting point of a comprehensive audit of a public enterprise, which covers aspects of economy, efficiency and effectiveness, is the preparation of an audit programme based on the study of decisions relating to the setting up of the enterprise, its objectives, the areas of operation, organisation, financial and operational details available in the annual reports and accounts, capital and operational budgets, deliberations of the board of directors, material in the earlier audit inspection reports on the enterprise and other relevant available papers. These audit programmes (or guidelines) identify the areas/aspects which require further detailed audit analysis and criteria, the data required for such analysis and the sources of such data, the extent of the audit analysis including the test checks to be applied and the instructions to the audit parties assigned to the work.

The areas covered by comprehensive audit are those of investment decisions, project formulation and management, organisation, delegation of powers and management information systems, organisational effectiveness, capacity utilisation, management of equipment, plant and machinery, production performance, use of materials, productivity of labour, idle capacity, costs and prices, development of complementary ancillary small scale industries, materials management, sales and credit control, budgetary and internal control systems, etc. The areas covered in comprehensive audit will naturally vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations. Some of the broad areas are listed below:

- Comparison of overall capital cost of the project with the approved planned costs.

- Production or operational outputs *vis-a-vis* under-utilisation of the installed capacity.
- Systems of project formulation and implementation.
- Cost control measures.
- Research and development programmes.
- System of repairs and maintenance.

Question 4

Write a short note on - Propriety Audit. *(4 Marks) (Final May 2003)*

Answer

Propriety Audit: Propriety Audit stands for verification of transactions on the tests of public interest commonly accepted customs and standards of conduct. E.L. Kohler has defined the term propriety as "that which meets the tests of public interest, commonly accepted customs and standards of conduct, and particularly as applied to professional performance, requirements of law, government regulations and professional codes". Instead of too much dependence on documents, vouchers and evidence, it shifts the emphasis to the substance of the transactions and looks into the appropriateness thereof on a consideration of financial prudence, public interest and prevention of wasteful expenditure. Thus propriety audit is concerned with scrutiny of executive actions and decisions bearing on financial and profit and loss situation of the company with special regard to public interest and commonly accepted customs, and standards of conduct. It is also seen whether every offer has exercised the same vigilance in respect of expenditure incurred from public money, as a person of ordinary prudence would exercise in respect of expenditure of his own money under similar circumstances. Propriety requires the transactions, and more particularly expenditure, to conform to certain general principles. These principles are:

(i) that the expenditure is not *prima facie* more than the occasion demands and that every official exercises the same degree of vigilance in respect of expenditure as a person of ordinary prudence would exercise in respect of his own money;

(ii) that the authority exercises its power of sanctioning expenditure to pass an order which will not directly or directly accrue to its own advantage;

(iii) that funds are not utilised for the benefit of a particular person or group of persons and

(iv) that, apart from the agreed remuneration or reward, no other avenue is kept open to indirectly benefit the management personnel, employees and others.

The Parliament and Government, with a view to knowing the standards of efficiency, propriety, cost consciousness and economy, have already come up with some provisions in the

Companies Act, 1956 having direct or indirect bearing on propriety; some of these provisions are:

(i) Section 209(1) (d) relating to Cost Accounting Records.

(ii) Section 227(1A) requiring enquiry into certain specified matters.

(iii) Section 227(4A) requiring a supplementary statement on matters specified in the Manufacturing and Other Companies (Auditor's) Report Order.

(iv) Section 233B - requirement of Cost Audit.

(v) Section 619(3)(a) requiring a supplementary statement in respect of the Government Companies on matters specified.

(vi) Additional information in Schedule VI, Part II.

Problems in propriety audit, however, arise mainly because of its distinct nature. The expression "propriety" is a moral term and can be understood by reference to the concept of morality accepted by the society at a given time. In any auditing, the essential test lies in formulation of auditing propositions. In the audit of financial accounts by reference to financial and legal requirements, propositions are built up about happening of events, existence, accuracy, title, ownership, compliance with law and internal regulations, etc., which are all verifiable. Propriety audit has an inherent element of subjectivity because it is very difficult to establish standards of public interest, commonly accepted customs, standards for conduct which are not firm basis for audit evaluation. To take care of this situation, the C&AG has developed the norms of propriety for expenditure of public funds in our country and this has been discussed in the study above. By laying down the standards of propriety for Government expenditure the C&AG has really tried to tackle in a practical way the complex problem of subjectivity inherent in a situation calling for propriety consideration. The element of subjectivity has caused proper discharge of duty very delicate and demands discretion, but wisdom of taking commercial decisions under dynamic environment (the economic, social and political) must be evaluated with reference to the circumstances in which these were taken and therefore, the auditor in his field must reconstruct such circumstances. The judgement of the auditor must be objective as otherwise it would dampen the initiative of management and others in taking commercial decisions and propriety audit would prove itself to be counter productive.

Question 5

Define Propriety Audit? What are the principles involved regarding Propriety Audit in Public Sector undertakings? (8 Marks) (Final Nov 2003)

Answer

Definition of Propriety Audit : Propriety Audit stands for verification of transactions on the test of public interest commonly accepted customs and standards of conduct. E.L. Kohler defined the term propriety," as that which meets the tests of public interest, commonly accepted customs and standards of conduct and particularly as applied to professional performance, requirements of law, Government regulations and Professional Codes". On an analysis, the tests boil down to tests of economy, efficiency and faithfulness. Thus propriety audit is concerned with scrutiny of executive actions and decisions bearing on financial and profit and loss situations of the company with special regard to public interest and commonly accepted customs and standards of conduct. It is also seen whether every officer has exercised the same vigilance in respect of expenditure incurred from public money, as a person of ordinary providence would exercise in respect of expenditure of his own money under similar circumstances.

Propriety Audit in PSUs: The scope and extent of audit in PSUs is not restricted to financial and compliance audit; it extends also to efficiency, economy and effectiveness with which these operate and fulfil their objectives and goals. Another aspect of audit relates to questions of propriety; this audit is directed towards and examination of management decisions in sales, purchases, contracts, etc. to see whether these have been taken in the best interests of the undertaking and conform to accepted principles of financial propriety. Propriety requires the transaction involving expenditure to conform to general principles as under:

1. That expenditure is not *prima facie* more than occasion demands and the every official exercise the same degree of vigilance in respect of expenditure, as a person of ordinary providence would exercise in respect of his own money.
2. That the authority exercises its power of sanctioning expenditure to pass an order which will not directly or individually accrue its own advantage.
3. That the funds are not utilised for the benefit of a particular person or a group of persons.
4. That, apart from the agreed remuneration or reward, no other avenue is kept open to individually benefit the management personnel employees and others.

Question 6

Write a short explanatory note on - Areas of propriety audit under Section 227(1A) of the Companies Act, 1956. (4 Marks) (Final May 2004)

Answer

Areas of propriety audit under Section 227(1A)

Section 227(1A) of the Companies Act, 1956 requires the auditor to make an enquiry into certain specific areas. In some of the areas, the auditor has to examine the same from propriety angle as to:

(i) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members;

(ii) whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company;

(iii) where the company is not an investment company within the meaning of section 372 or a banking company, whether so much of the securities have been sold at a price less than that at which they were purchased by the company;

(iv) whether personal expenses have been charged to revenue

Question 7

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

(i) Assets and Investments, and

(ii) Inventory and Contracting *(8 Marks)(Final Nov 2006)*

Answer

(i) Assets and Investments

(i) Have the dates of installation and commissioning of plant and machinery been clearly fixed by the authority to whom the powers have been delegated by the board?

(ii) Indicate whether the property and assets registers are posted upto date and are reconciled with the financial books?

(iii) Examine and indicate whether the company has a system of monitoring the timely recovery of outstanding dues? Highlight the significant instances of failure of the system, if any.

(iv) Indicate whether the cash and imprest balances were physically verified during the year on a regular basis by an authorized officer? Highlight the inadequacies in this regard, if any.

(v) Indicate whether the company has laid down an investment policy? If yes, please indicate the following:

(a) Authority which approved the policy. (b) Is it in accordance with the laws, rules and regulations applicable to the company? (c) in our opinion are there any defects in the policy? (d) Has the company followed it in case of all material investments made during the year? (e) Were the investments made by the company in its the best interest. (f) Is the short fall in the market value of the current investments and permanent diminution in the value of long terms investments reflected in the books? If not, describe the failure.

(vi) Indicate whether the deposits with banks/ financial Institutions and others have been in accordance with laws, rules, regulations etc. applicable to the company? Further state whether these were properly authorized by the competent authorities.

(ii) Inventory and contracting

(i) Examine whether the company has prescribed the following in regard to the management to stores:

a. Maximum and minimum limits of stores and spares.

b. Economic order quantity for procurement of stores.

(ii) Indicate whether the company usually makes advance payments to suppliers contractors? If so indicate whether the company has an efficient system for monitoring and adjusting such advances?

NOTE

10

AUDITS OF BANKS

Question 1

Your firm has been appointed as Central Statutory Auditors of a Nationalised Bank. The Bank follows financial year as accounting year. State your views on the following issues which were brought to your notice by your Audit Manager:

(a) In computing the aggregate of funded and non-funded exposure of a constituent for purpose of assigning risk weight in regard to capital adequacy, the bank "Netted off' the credit balance of Rs.10 lakhs in their Current Account against the total exposure of Rs.1 crore. (4 Marks)

(b) The bank has recognised on accrual basis income from dividends on securities and Units of Mutual Funds held by it as at the end of financial year. The dividends on securities and Units of Mutual Funds were declared after the end of financial year. (4 Marks)

(c) The bank is a consortium member of Cash Credit Facilities of Rs.50 crores to X Ltd Bank's own share is Rs.10 crores only. During the last two quarters against a debit of Rs.1.75 crores towards interest the credits in X Ltd's account are to the tune of Rs.1.25 crores only. Based on the certificate of lead bank, the bank has classified the account of X Ltd as performing. (4 Marks)

(d) In case of all such advances which have been classified as non-performing for the first time during the current financial year, only the last date of the financial year has been reckoned as the date of account becoming non-performing. (4 Marks) (Final May 2000)

Answer

(a) The RBI requires banks to adhere to certain capital adequacy norms to ensure that they have adequate capital in relation to the credit and other risks undertaken by them. In accordance with the circular issued by the RBI, while computing risk adjusted value of assets netting may be done only for advances collateralised by cash margins or deposits and in respect of assets where provision for doubtful debts have been made. The circular further states that in calculating the aggregate of funded and non-funded exposure of a borrower for the purpose of assignment of risk weight, banks may "net off' against the total outstanding exposure of the borrower, credit balance in current account which are free from any lien. Accordingly the treatment of netting off followed by the bank is in order.

(b) It is not a prudent practice to treat dividend on shares of corporate bodies and units of mutual funds as income unless these are actually received. Accordingly, income from dividend on shares of corporate bodies and units of mutual funds should be booked on cash basis. In respect of income from government securities and bonds and debentures of corporate bodies, where interest rates on these instruments are pre-determined, income could be booked on accrual basis, provided interest is serviced regularly and as such is not in arrears. It was further, however, clarified that banks may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the central government or a State government. Banks may book income from dividend on shares of corporate bodies on accrual basis, provided dividend on the shares has been declared by the corporate body in its annual general meeting and the owner's right to receive payment is established. This is also in accordance with AS 9 as well. In the instant case, the recognition of income by the bank on accrual basis is not in order

(c) The bank is a consortium member of cash credit facilities of Rs.50 crores to X Ltd. Bank's own share is Rs.10 crores only. During the last two quarters against a debit of Rs.I.75 crores towards interest, the credits in X Ltd's account are to the tune of Rs.1.25 crores only. Sometimes, several banks form a group (the 'consortium') under the leadership of a 'lead bank' to make advance to a large customer on same conditions and security with proportionate rights. In such cases, each bank may classify the advance given by it according to its own experience of recovery and other factors. Since in the last two quarters, the amount remains outstanding and, thus, interest amount should be reversed. This is despite the certificate of lead bank to classify that the account as performing. Accordingly, the amount should be shown as non-performing asset.

(d) It is wrong to take the Balance Sheet date for purposes of classification. In this context, it is important to note the concept of past due. An amount should be considered as past due when it remains outstanding for 30 days beyond due date. For example, if any SSI loan amount, the repayment of term loan installment falls due for payment on December 31 and is not paid; the amount would become past due if it remains unpaid for 30 days beyond that date. In case of terms loans, if interest or installment of principal is in arrears for any two quarters out of four quarters although default may not be continuously for two quarters during the year by applying past due test, it should be classified as non-performing asset and from that date provision should be made. In the case of other advances, outstanding in the last two quarters would be enough to classify the amount as such non-performing asset if no transaction appears in the last two quarters.

As per RBI Circular dated January 29, 1997, if the account of the borrowers have been regularised before the balance sheet date by repayment of overdue amounts through genuine sources and not by sanction of additional facilities, the account need not be treated as NP A in spite of payment of interest and installment were in arrear for two quarters. Bank should, however, ensure that the account remains in order subsequently and a solitary credit entry made in the account on or before the balance sheet date which extinguished the overdue amount of interest or instalment of principal is not reckoned as the sole criterion for treating the account as a standard asset.

It has been further clarified that in respect of accounts where there are potential threats of recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, it will not be prudent for banks to classify them first as sub-standard and then as doubtful after expiry of two years from the date of account has became NPA. It should be straight way classified as doubtful asset or loss asset, as appropriate, irrespective of the period for which it has remained as NPA.

Question 2

What is the income recognised in the case of 'non-performing' assets of bank?

(4 Marks)(Final Nov 2000)

Answer

The Reserve Bank of India has issued guidelines to be followed by all scheduled commercial banks excluding RRBs for income recognition, asset classification, provisioning and other related matters. Conceptually speaking, a credit facility becomes non-performing when it ceases to generate income for a bank. The guidelines require that in the case of Non-performing Asset (NPA) accounts, the income should be recognised only on realisation irrespective of the system of accounting followed by the bank. The guidelines further provide that if interest income from assets in respect of a borrower becomes subject to non-accrual, fees, commission and similar income with respect to the same borrower that have been accrued ceases to accrue in the current period should be reversed or provided for with respect to past period, if uncollected. Where interest is partly realised on any non-performing asset, such interest can be taken to the profit and loss account. However, it should be ensured that the credits in the account towards interest are not out of fresh/additional credit facilities sanctioned to the borrower concerned.

Advances secured against term deposits, national saving certificates eligible for surrender Indira Vikas Patras, Kisan Vikas Patras and life insurance policies have been exempted from the above guidelines. Thus, interest on such advances may be taken to income account on due dates provided adequate margin is available in the respective accounts.

Question 3

Describe the procedure for verification of the following balances appearing in the account books of a bank:

(i) Drafts paid without advice (4 Marks)

(ii) Branch adjustment account (4 Marks) (Final Nov 2000)

Answer

(i) Drafts paid without advice: This balance is in the nature of a suspense account in as much as it represents payments made on account of drafts issued by other branches but for which the relevant advice from those branches have not been received. It is, therefore, most important to examine the system of internal control operating in the bank in this respect. The testing of the internal control system has to be made mainly with regard to the following:

(i) the system of verifying the authenticity of the draft by reference to specimen signature of the signing authority and the *prima facie* correctness and completeness of the draft in all respects;

(ii) the system of co-relating drafts paid with advices subsequently received; and

(iii) the system of sending reminders where advices are not received within a reasonable time and the recording of reasons for their non receipt.

The composition of the balances appearing in this account should be verified with particular reference to any long outstanding items. The auditor should also verify whether the items appearing in this account have been subsequently cleared on receipt of the relevant advices. It would also be useful to have on record the names and addresses of the payees of such drafts. The auditor may also seek confirmation of transactions relating to such outstanding cases.

(ii) Branch Adjustment Account: In the final balance sheet of the bank, this balance represents the difference between inter branch debits and credits and should normally comprise items which are in transit as on the closing date. This account is the one which is most commonly used by unscrupulous persons in committing a fraud. The verification of this account is, therefore, of great importance. The procedure for verification is as follows:

(a) See that all branch accounts are periodically reconciled.

(b) Check all adjustments in the account and ensure that the adjustments are done properly and supported by adequate documentary evidence as to its validity.

(c) Verify that reversal entries are made under proper authority and after due explanation and evidence.

Question 4

As a branch auditor of a nationalised bank, how would you verify the following?

(i) Advances to DOT COM Companies. (4 Marks)

(ii) Balances in account of a bank situated in a foreign country. (4 Marks) (Final May 2001)

Answer

(i) Advances to DOT COM Companies

(1) Evaluate the efficacy of internal control system in general to ascertain whether an advance is made only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank. The sanction for an advance must specify, among other things, the limit of borrowing, nature of security, margin to be kept, interest, terms of repayment, etc. Also see that all the necessary documents, e.g., agreements, demand promissory notes, letters of hypothecation, etc. have been executed by the parties before advances are made.

(2) Examine loan documents such as certificate of commencement of business (in the case of public limited companies), resolution of board of directors, and resolution of shareholders (in cases covered by Section 293(1)(d) of the Companies Act, 1956).

(3) Verify the business plan of the company especially where the revenue model is in place. Verify whether the company depends only on outside funding or can self generate funds.

(4) Examine in case the security is in the form of mortgage, apart from mortgage deed (in the case of English Mortgage) or letter of intent to create mortgage (in the case of Equitable Mortgage), the evidence of registration of the charge with the Registrar of Companies.

(5) Review the operation of advance account to see that limit is not generally exceeded; that the account is not becoming stagnant; that the customer is not drawing against deposits which are not free from lien; that the account is not window-dressed by running down overdrafts at the year end and again drawing further advances in the new year, etc.

(6) Examine whether there is a healthy turnover in the account. It should be seen that the frequency and the amounts of credits in the account are commensurate with the sanctioned limit and the nature and volume of business of the borrower. Any unusual items in the account should be carefully examined by the auditor. If the auditor's review indicates any unhealthy trends, the account should be further examined. The auditor's examination should also cover transactions in the post-

balance sheet date period. Large transactions in major accounts particularly as at the year-end may be looked into to identify any irregularities in these accounts.

(7) Review periodic statements, cash flow statements, latest financial statements, etc. to assess the recoverability of advances.

(8) Verify whether the advance is secured and determine whether the security is legally enforceable, i.e., whether the necessary legal formalities regarding documentation, registration, etc., have been complied with; whether the security is in the effective control of the bank; and to what extent the value of the security, assessed realistically, covers the amount outstanding in the advance.

(9) Ensure that proper provisioning norms have been applied in view of non-observance of terms, coupled with irregular payment of interest and default in repayment of instalments, if any.

(ii) Balances in Account of a Bank situated in a Foreign Country

(1) Verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at the year-end.

(2) Review the reconciliation statements and pay particular attention to the following.

(i) Examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to revenue for the year have been so taken. This should be particularly observed when the bills collected, etc., are credited with net amount and entries for commission, etc. are not made separately in the statement of account.

(ii) Examine that no cheque sent or received in clearing is outstanding. As per the practice prevalent among banks, any cheques returned unpaid are accounted for on the same day on which they were sent in clearing or on the following day.

(iii) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.

(3) Examine the large transactions in inter-bank accounts, particularly towards the year-end, to ensure that no transactions have been put through for window-dressing.

(4) Check original deposit receipts in respect of balances in deposit accounts in addition to confirmation certificates obtained from banks in respect of outstanding deposits.

(5) Check whether these balances are converted into the Indian currency at the exchange rates prevailing on the balance sheet date and ensure compliance with AS 11 on "Accounting for the Effects of Changes in Foreign Exchange Rates".

Question 5

As statutory central auditors of a Nationalised Bank, what special points are to be borne in mind in the audit of compliance with "Statutory Liquidity Ratio" (SLR) requirements?

(8 Marks) (Final May 2002)

Answer

Banking companies are required to maintain in India cash, gold or unencumbered approved securities on account as determined by RBI from time to time of total of their demand and time liabilities in India as on last Friday of the second preceding fortnight is known as "Statutory Liquidity Ratio (SLR)". Central statutory auditors have been asked by RBI to verify the compliance of SLR on 12 odd dates in different months not having Fridays. Special points required to be followed in this regard are:

(i) Composition of items of DTL as per circulars/instructions of RBI.

(ii) Verification of trial balance and cash balance for 12 selected dates by Branch auditors.

(iii) Inclusion of demand and time liabilities in Consolidated Statement regarding DTL position based on the returns received from the branches.

(iv) Net credit balance in Branch Adjustment Account including these relating to foreign branches, interest on deposits reversed in the next half, have been included in liabilities.

(v) In computation of liquid assets, deposits maintained with RBI, cash balance with itself or RBI, excess balance maintained with RBI under section 42, net balance in current account are all treated as cash.

(vi) Price of gold taken does not exceed market price.

(vii) Number of unaudited branches.

Question 6

Answer the following:

Describe the audit procedures to be followed by a Statutory Auditor of a bank for audit of contingent liabilities. *(8 Marks) (Final Nov 2002)*

Answer

Verification of Contingent Liabilities: The auditor, in general, has to ensure that all contingent liabilities are identified and properly valued and thus, review the internal control system, subsequent events and obtain management representation. In respect of different items, the procedure is given below:

(i) ***Claims against the bank not acknowledged as debts***: In this case, the auditor should examine the relevant evidence, i.e., correspondence with lawyers, claimants, workmen's unions, etc. The auditor should also review the minutes of the meetings of the board of directors, audit committees, contracts, list of pending legal cases, any show cause notices received, and correspondence relating to payment of taxes, duties, etc.

(ii) ***Liability on account of partly paid investments***: If the bank is holding any partly paid shares, or any other investments, the auditor should examine whether the uncalled amounts are shown as contingent liability.

(iii) ***Liability on account of outstanding foreign exchange contracts***: The auditor will have to verify the register maintained for the net position in relation to each foreign-currency and find out whether the position is generally squared and not uncovered by a substantial amount. The net position as reported in the financial statements may also have to be verified with reference to the foreign exchange position report prepared by the back-office.

(iv) ***Guarantees given on behalf of constituents***: The auditor should ascertain the internal control system over issue of guarantees and whether they are issued under proper sanctions, whether adherence to limits sanctions for guarantees is ensured, whether margins are taken from customers as per prescribed procedures, whether there are adequate controls over unused guaranty forms, etc. The auditor should examine the guarantee register and whether the amounts of guarantees that are still outstanding are shown as a contingent liability. The guarantees outstanding should be disclosed separately for guarantees within India and outside India.

(v) ***Acceptances, endorsements and other obligations***: This includes letters of credit opened by the bank on behalf of its customers and bills drawn by the bank's customers and accepted or endorsed by the bank. The auditor should in such cases evaluate the adequacy of internal controls over issue of letters of credit, over custody of unused forms, etc. The auditor should also verify the balance of letters of credit from the register maintained by the bank. As far as other acceptances and endorsements are concerned, the auditor should study the arrangements made by the bank with its customers and should test check the amounts of the bills with the register maintained by the bank for such bills. In case the bank has issued letters of comfort, the auditor should examine whether the bank has incurred a potential financial obligation by issuing such a letter. If such an obligation has been cast, the amount has also to be shown as a contingent liability.

(vi) ***Bills for collection***: Bills held by a bank for collection on behalf of its customers are to be shown as a contingent liability in the balance sheet. These bills are generally bills of exchange accompanied by documents of title to goods. The bank may get these bills for collection from its customers or from its other branches. The auditor should while finding out the total amount of bills outstanding at the year-end for collection, examine the collections made subsequent to the date of the balance sheet to obtain further evidence about the existence and completeness of the bills for collection.

Question 7

Discuss the scope of "concurrent audit" in the banks. *(8 Marks) (Final May 2003)*

Answer

Scope of Concurrent Audit: Concurrent audit is an examination which is contemporaneous with the occurrence of transactions. It attempts to shorten the interval between a transaction and its examination by an independence person not involved in its documentation. There is an emphasis in favour of substantive checking in key areas rather than test checking. This audit is essentially a management process integral to the establishment of effective control to preclude incidence of serious errors and fraudulent manipulations. The concurrent audit system is regarded as part of bank's early-warning system to ensure timely detection of irregularities and lapses which helps in preventing fraudulent transactions at branches. It is, therefore, necessary for the bank's management to bestow serious attention to the implementation of various aspects of the system such as selection of branches/coverage of business operations, appointment of auditors, appropriate reporting procedures, follow-up/rectification processes and utilisation of the feedback from the system for appropriate and quick management decisions.

As early as in 1993, certain guidelines on concurrent audit system in commercial banks were issued, setting out the scope and coverage of concurrent audit system and its reporting procedures and calling upon banks to introduce/revamp their concurrent audit system based on these guidelines. Thereafter, the Reserve Bank of India has reviewed, *inter alia*, the working of concurrent audit system in banks and given its recommendations for improving it. Further, some of the public sector banks have sought additional guidelines on the system's scope, coverage, reporting procedures, etc. A need was, therefore, felt to have a relook at the existing guidelines and review certain norms to ensure that the system is more compact and focused in its approach and also facilitate effective implementation. These guidelines are mandatory and all banks are required to cover 50 percent of total deposits and 50 per cent of total advances under this audit. This will mean that all banks will have to put their large branches under this audit. Further, the following may be noted:

(1) The scope of concurrent audit should be wide enough to cover certain fraud-prone areas like handling of cash, deposits, safe custody of securities, investments, overdue bills, exercise of discretionary powers, sundry and suspense accounts, inter-branch reconciliation, clearing differences, foreign exchange business including Nostro accounts, off-balance sheet items like letters of credit and guarantee, treasury functions and credit-card business.

(2) The detailed scope of the concurrent audit should be clearly and uniformly determined for the Bank as a whole by the Bank's Inspector and Audit Department in consultation with the Bank's Audit Committee of the Board of Directors.

(3) In determining the scope, importance should be given to checking high-risk transactions having large financial implications as opposed to transactions involving small amounts.

The scope of concurrent audit can further be defined with reference to several banking operations such as treasury, investment banking, etc. As far as activities are concerned, it would include cash, investments, deposits, advances, foreign exchange transactions, house keeping high value transaction, safe custody … etc. It is however, contemplated by RBI that, "a concurrent auditor may not sit on judgement of the decisions taken by the branch manager or an authorized official. However, the auditor will have to see whether, the transactions are within the parameters laid down by the Head Office and do not violate the instructions of the RBI, and are within the delegated authority".

Question 8

As statutory central auditors of a Nationalized bank, what special points are to be borne in mind in the audit of compliance with "Statutory Liquidity Ratio" (SLR) requirements?

(8 Marks) (Final Nov 2003)

Answer

Compliance with SLR Requirements: The Reserve Bank of India requires statutory central auditors of banks to verify the compliance with SLR requirements of 12 odd dates in different months of a financial year not being Fridays. The resultant report is to be sent to the management of the bank and to the Reserve Bank. To verify compliance with SLR requirements, the statutory auditor has to examine two aspects:-

(i) The correctness of the figure of the demand and time liabilities in India (DTL) at the close of business on the reporting Friday relevant to the dates selected by the auditor, and

(ii) Maintenance of prescribed percentage of liquid assets on the selected data considering the DTL position on the relevant reporting Friday.

Special points to be noted are:

1. Obtain an understanding of the relevant circumstances of the RBI, particularly regarding composition of items of DTL.
2. Require the branch auditors to verify the correctness of the trial balances relevant to the 12 dates selected by him. The branch auditors should also be specifically requested to examine the cash balance at the branch on the selected dates. The DTL position to the examined will be as on the last Friday of the Second preceding fortnight, i.e., April 11. The position of cash, gold and approved securities shall be as of May 1.
3. Review the relevant returns/received from un-audited branches to identify any obvious errors or omissions or inconsistencies.

4. Examine, on a test basis, the consolidations regarding DTL position prepared by the bank with reference to the related returns received from branches. The auditor should examine whether demand liabilities comprise only those liabilities that must be met on demand.
5. Specifically examine the following items have been excluded from liabilities.
   - Amount received from deposit insurance and export credit guarantee corporations (ECGC) towards claims in respect of guarantees involved and held pending adjustment of the same towards the related advance.
   - Amounts received from Court Receiver.
   - Amount received from insurance companies as a result of “excess claims”.
   - Part amount of recoveries received from the borrowers.
   - Amounts received in Indian currency against import bills and held in sundry deposits pending receipt of final notes.
   - Unadjusted deposit/balances buying in link branches for agency business like dividend warrants, interest warrant, refund of application money.
6. Specifically examine that the following items have been included in liabilities
   - Net credit balance in branch adjustment accounts including these relating to foreign branches.
   - Interest on deposit as at the end of the firm half year reversed in the beginning of the next half-year.
7. Verify that in computation of liquid assets, the following are treated as cash.
   - The deposit maintained with RBI by a banking company incorporated outside India under Section 11(2) of the Banking Regulation Act.
   - Any balances maintained by a scheduled bank with the Reserve Bank in excess of the balance required to the maintained by it under section 42 of the Reserve Bank of India Act.
8. Test check the relevant records to verify the amount of unencumbered approved securities held by the bank on the selected dates. Examine whether the valuation of approved securities has been done with reference to cost price, market price, book value or face value or a combination of these methods as may be specified by the Reserve Bank of India from time to time.

Question 9

How will you evaluate the internal control system in the area of credit card operations in a bank? (8 Marks) (Final May 2004)

Answer

Evaluation of internal control system in the area of credit card operations: The evaluation of internal control system in the area of credit operations in the bank would have to be done in respect of following aspects:

1. **Segregation of Responsibilities:** The activities relating to credit card operations can be divided in specific areas, namely, beginning from the receipt of application form, evaluating the credit assessment, sanctioning the issuance of card, making and despatch of card would form part one of operations. Later on, particularly, from the accounting view, the significant operations would include receipt of statement from vendors/merchants, raising bills to customers, realisation either by directly debiting the customers' accounts or payment received through cheques, periodic reconciliation, etc. While evaluating internal controls, it would have to be seen that adequate division of responsibilities have been carried out to avoid any collusion and independent checks have been built in the system. While evaluating the internal control, it may also be considered whether some part of the operations have been outsourced or performed in-house.
2. **Credit Assessment System:** Each application is scrutinised with reference to different parameters for assessing the credit limits to be awarded. The system must be able to generate exception reports at this stage itself. In fact, at the application stage itself, the system must ensure that the applicant was holding one card earlier or has defaulted in respect of any other agency.
3. **Control Over Issuance of Cards:** The internal control system must ensure that the cards are under the control of responsible official. A detailed record along with relevant pin codes, etc. have been kept. See that the system has built-in features that it is almost impossible to make counterfeit cards as also photographs are affixed to prohibit any unauthorised use of the same.
4. **Reconciling Merchant Records:** It is to be checked whether the system has built-in flexibility of reporting of the payments to be made to merchants and making prompt payment to them. Simultaneously, it should be seen that customer statements are also generated automatically and despatched to them.
5. **Periodic Reconciliation and follow-up:** It may be seen whether periodic reconciliation of customers' accounts is done and regular follow-up of overdue accounts takes place. The person who are responsible for maintaining customers' records are not entrusted with the responsibility of reconciliation and follow-up.

Question 10

Write a short note on - Principal Enactments Governing Bank Audit.(4 Marks) (Final Nov 2004)

Answer

Principal Enactments Governing Bank Audit: There is an elaborate framework governing the functioning of banks in India. The whole of banking sector can be categorise into several sectors such as commercial banks, cooperative banks, foreign banks, etc. The principal enactments which govern the functioning of various types of bank are as under:

(a) Banking Regulation Act, 1949;

(b) Banking Companies (Acquisition of Transfer of Undertakings) Act, 1970;

(c) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980;

(d) State Bank of India Act, 1955;

(e) State Bank of India (Subsidiary Banks) Act, 1959

(f) Regional Rural Banks Act, 1976;

(g) Companies Act, 1956; and

(h) Cooperative Societies Act, 1912 or the relevant State Cooperative Societies Acts.

Besides, the above enactments, the provisions of Reserve Bank of India Act, 1934, also affect the functioning of banks. The Act gives wide powers to Reserve Bank of India to give directions to Banks; such directions also have considerable effect on the functioning of banks.

Question 11

What are the exceptions to the general rule of treating advances as Non-performing Assets (NPAs)? (4 Marks) (Final May 2005)

Answer

Non-performing Assets: RBI has laid down norms for classification of assets and provisioning norms for NPAs. However, certain exceptions to these norms are discussed below:

(i) Temporary deficiencies, e.g., non availability of current drawing power due to non-receipt of latest stock statement, temporary delay in renewals of limits on due date, etc.

(ii) *Natural Calamities:* Where, in the wake of natural calamities, short-term agricultural loans are converted into term loans or there is rescheduling of repayment period or fresh short-term loans are sanctioned, the term loan as well as fresh short term loan may be treated as current dues and need not be classified as NPA.

(iiii) *Facilities Backed by Central Government Guarantees*: Credit facilities backed by guarantee of the Central Government though overdue should be treated as NPA only when the government repudiates its guarantee when invoked (this exemption is only for the purpose of asset classification and provisioning and not for the purpose of recognition of income).

(iv) Advances to "On Lending" arrangements are also exempted under this category.

Question 12

Write a short note on - Vostro and Nostro Accounts. (4 Marks) (Final May 2005)

Answer

Vostro and Nostro Accounts: Bank's maintain stocks of foreign currencies in the form of Bank Accounts with their overseas branches/correspondents. Such foreign currency accounts maintained by Indian banks at other overseas centres is designated by it as "Nostro Account". For example, all banks in India would be maintaining a US Dollar Account with their New York office/branch/correspondents, such account would be designated by the Indian office as

Nostro Account. "Vostro Account" is the opposite of Nostro accounts. Here a foreign bank in another country maintains stocks of Indian rupees with their Indian branch/correspondent/local bank. Such Indian Rupee Accounts are designated as a Vostro Account. For example, a German Bank might maintain a Vostro Account in rupees in terms with Indian Bank. While examining the transaction in foreign exchange, the auditor should also pay attention to reconciliation of Nostro Accounts with the respective minor account. The amount in the Nostro account is stock of foreign currency in the form of bank accounts with the overseas branches and correspondents. Unreconciled Nostro Accounts, on an examination, may reveal unauthorized payments from the foreign currency account, unauthorized withdrawals, and unauthorized debit to minor account. The auditor should also evaluate the internal control with regard to inward/ outward messages. The inward/ outward messages should be properly authenticated and discrepancies noticed, should be properly dealt with, in the books of accounts.

The auditor should also verify whether prescribed procedure in relation to inter bank confirmation in the Vostro account is followed or not. In case balance confirmation certificate have been received but the same have not been reconciled, or where confirmation has not been received the same should be reported, in respect of each Vostro Account.

Question 13

Write a short note on - Valuation of Investments "held to maturity" by banks.

(4 Marks)(Final Nov 2005)

Answer

Valuation of Investments "Held to Maturity"

The banks are required to classify their entire investment portfolio into three categories: held to maturity (HTM), available for sale (AFS), and held for trading (HFT). Securities acquired with the intention to hold them up to maturity should be classified under HTM category. Thus, this category will comprise only debt securities (e.g., debentures, redeemable bonds, government securities), preference shares and similar securities having a defined period of maturity, except that equity shares of subsidiaries/joint ventures have also to be included in HTM category.

(i) These investments need not be marked to market and will be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortized over the period remaining to maturity. For instance if a bond is acquired at say Rs.90 and it is redeemable at Rs.100 after three years, the discount, i.e., Rs.10 should also be amortised as income over the next three years unless there is significant uncertainty of receipt of full face value on maturity.

(ii) Any diminution, other than temporary should be recognised in the value of their investments in subsidiaries/JVs and provided for. Such diminution should be determined and provided for each investment individually.

Question 14

As a Statutory Auditor, of a bank, how would you verify the "Sacrifice" on Non-Performing Assets for which Corporate Debt Restructuring has been undertaken?

(6 Marks)(Final May 2006)

Answer

Corporate Debt Restructuring and Sacrifice Element: The Revised Guidelines on Corporate Debt Restructuring (CDR) Mechanism specified that in case of rescheduling of accounts, the element of interest to be computed in present value terms. The guidelines state that the sacrifice should be computed as the difference between the present value of future interest income reckoned based on the current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring and the interest charged as per the restructuring package discounted by the current BPLR as on the date of restructuring plus appropriate term premium and credit risk premium as on the date of restructuring. Accordingly, the following steps may be taken in this regard:

(i) Check that the appropriate credit risk premium for the specific borrower category for all restructured accounts.

(ii) Ascertain appropriate rate of discount.

(iii) Check the computation of present value interest and the sacrifice amount.

(iv) See that the entire amount should be written off or provided for in case sacrifice is positive.

(v) Verify provision of adequate security coverage of the loan in case restructuring of principal amounts.

Question 15

Explain the scope of concurrent audit of a bank with reference to Reserve Bank of India guidelines.

(16 Marks)(Final Nov 2006)

Answer

Scope of concurrent audit of banks with reference to RBI guidelines

The following are the areas to be covered:

(i) Daily cash transactions with reference to abnormal receipts and payments. This will include currency chest transactions, major expenses met by cash, high value receipts and disbursements.

(ii) Purchase and sale of shares securities etc. Physical verification of investments and rates at which they are entered into.

(iii) Verification of procedure and documentation to open new current, savings, term deposit accounts, etc. Unusual operations noticed have to be thoroughly examined.

(iv) Verification of advances, overdrafts, temporary OD, Cash credit accounts, term loans, bills purchase, letters of credit etc. Procedure for sanction and documentation to be verified. Any deviation noticed to be examined in great detail.

(v) Foreign exchange transactions to be verified with reference to RBI guidelines.

(vi) Verification of balancing of all ledgers and registers, inter branch reconciliation calculation and verification of interest, discount, commission etc.

(vii) Revenue leakage to be detected.

(viii) Special efforts to be made in all fraud prone areas. The attempt should be to ensure that all effective measures are taken to prevent frauds.

(ix) Verification of high value transactions.

(x) Procedure for safe custody of security forms with the branch.

(xi) Whether all procedures for tax deduction at source are followed and the tax so deducted are deposited into Government Account within the time fixed.

(xii) Verification of returns, statements, calculation of capital adequacy ratio and compliance with requirements of government business.

(xiii) Study of RBI and Internal Inspection reports statutory auditors report and compliance thereto.

(xiv) Whether the customers' complaints are dealt with promptly.

Question 16

How would you verify "Acceptances, Endorsements and other obligations" appearing in the Balance Sheet of a bank ? *(6 Marks) (Final May 2007)*

Answer

Acceptances, Endorsements and Other Obligations: This item includes the following balances:

(a) letters of credit opened by the bank on behalf of its customers and

(b) bills drawn by the bank's customers and accepted/endorsed by the bank.

Letters of credit: Evaluate the adequacy of the internal controls over LC Forms e.g. custody, maintenance of records, periodical verification, reconciliation etc.

Verify the balance of LC from the Register maintained by the bank to ascertain the amount of LC and payments made under them.

Examine the guarantees of the customers, copies of the LC issued & security obtained for issuing LC.

In respect of other acceptances and endorsements the following procedure may be adopted.

(i) Examine the arrangements made by the bank with its customers.

(ii) Test check the amounts of bills with the register maintained by the bank.

(iii) Verify whether such bills are marked off in the register on payment at maturity.

Letters of comfort: Where letters of comfort has been issued, verify whether the bank has incurred a potential financial obligation under such a letter. If an obligation has been cast under letters of comfort, ensure that the amount has also been shown as contingent liability in the Balance Sheet.

Question 17

How are investments to be classified in the financial statements of a Bank?

(8 Marks) (Final Nov 2007)

Answer

Classification of Investments in the Financial Statements of a Bank

The entire investment portfolio of the banks (including SLR securities and non-SLR securities) should be classified under three categories viz., 'Held to Maturity', 'Available for Sale' and 'Held for Trading'.

However, in the balance sheet, the investments will continue to be disclosed as per the existing six classifications viz., (a) Government securities; (b) Other approves securities; (c) Shares; (d) Debentures & Bonds; (e) Subsidiaries/Joint Ventures and (f) Other (CP, Mutual Fund Units, etc)

Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposals.

Held to maturity

(i) The securities acquired by the banks with the intention to hold them up to maturity will be classified under ***Held to Maturity.***

(ii) The investments included under 'Held to maturity' should not exceed 25 per cent of the bank's total investments.

(iii) The following investments are to be classified under 'Held to Maturity' but will not be counted for the purpose of ceiling of 25% specified for the category:

    (a) Re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in their investment portfolio.

    (b) Investment in subsidiaries and joint ventures. [A joint venture would be one in which the bank, along with its subsidiaries, holds more than 25% of the equity.]

(c) The investments in debentures/bonds, which are deemed to be in the nature of an advance.

(iv) Profit on sale of investments in this category should be first taken to the Profit & Loss Account and thereafter be appropriated to the 'Capital Reserve Account', Loss on sale will be recognized in the Profit & Loss Account.

Held for Trading

The securities acquired by the banks with the intention to trade by taking advantage of the short-term price/interest rate movements will be classified under ***Held for Trading.***

The investments classified under held for trading category would be those from which the bank expects to make a gain by the movement in the interest rates/market rates. These securities are to be sold within 90 days.

Available for Sale

The securities which do not fall within the above two categories will be classified under ***Available for Sale.***

Profit or Loss on sale of investments in both the categories will be taken to the Profit & Loss Account.

Question 18

Write a short a note on - Contingent Liabilities for Banks. *(8 Marks) (Final Nov 2008)*

Answer

Contingent Liabilities for Banks: The third schedule to the Banking Regulation Act, 1949 requires the disclosure of the following as a footnote to the balance sheet.

(a) Contingent liabilities

(i) Claims against the bank not acknowledged as debts.

(ii) Liability for partly paid investments.

(iii) Liability on account of outstanding forward exchange contracts.

(iv) Guarantees given on behalf of constituents

(a) In India.

(b) Outside India

(v) Acceptances, endorsements and other obligations.

(vi) Other items for which the bank is contingently liable.

(b) Bills for collection.

11

AUDIT OF GENERAL INSURANCE COMPANIES

Question 1

Write a short note on - Incoming and Outgoing Co-insurance. (4 Marks) (Final May 2000)

Answer

Incoming and Outgoing Co-insurance: In cases of large risks, the business is shared between more than one insurer under co-insurance arrangements at agreed percentages. The leading insurer issues documents, collects premium and settles claims. Statement of accounts are rendered by the leading insurer to the other co-insurers. The auditor should verify incoming co-insurance and outgoing co-insurance as follows:

(i) ***Incoming Co-Insurance****:* The auditor should see that the Premium Account is credited on the basis of statements received from the leading insurer. In case, the statement is not received, the premium is accounted for on the basis of advices to ensure that all premium in respect of risks assumed in any year is booked in the same year. It would be advisable for the auditor to scrutinise the communication in the post-audit period and obtain a written confirmation to the effect that all incoming advices have been accounted for. The auditor should also verify claims provisions and claims paid with reference to advice received from the leading insurer.

(ii) ***Outgoing Co-Insurance****:* The auditor should scrutinise the transactions relating to the outgoing business, i.e. where the company is the leader. These should be checked with reference to the relevant risks assumed under policies and correspondingly for debits arising to the co-insurer on account of their share of claims

Question 2

What are the steps to be taken while auditing re-insurance transactions in an Insurance Company? (8 Marks) (Final Nov 2000)

Answer

Audit of Re-insurance Transactions: Section 101 A of the Insurance Act, 1938 provides that every insurer shall re-insure with Indian re-insurers such percentage of the sum assured on each policy as may be specified by the Insurance Regulatory and Development Authority (Authority) with the previous approval of the Central Government.

The percentage of the sum assured on each policy to be re-insured and different percentages are specified for different classes of insurance by the authority but no percentage so specified shall exceed thirty per cent of the sum assured on such policy. Further, the proportions in which the said percentage shall be allocated among the Indian re-insurers is also specified. Thus, reinsurance involves distribution of risks of a company. The insurance company may pass on the risk to other companies which means that reinsurance has been ceded involving payment of premium to the reinsurer by the company which has ceded the reinsurance. In turn, the ceding company receives commission on such premium and, if a claim is lodged against the risk ceded, it can recover a part of the claim from the accepting company.

The steps to be taken by the auditor while auditing re-insurance transactions in an insurance company are as follows:

(i) Examine terms and conditions as per the re-insurance treaties.

(ii) Vouch periodical statements of treaty returns for premium paid to the re-insurer, the commission received on such premiums and the recovery of claims from re-insurer in case of re-insurance ceded. Similarly, the premiums received, the commission paid on such premiums and the claims against re-insurance accepted should be checked.

(iii) Check whether commission has actually been received by the ceding company in case re-insurance treaties provide for commission on the profits realised by the companies accepting re-insurance on risks re-insured or provision of the same.

(iv) Check retention of funds if funds are to be retained as security for fulfilment of the treaties.

(v) Check that premium and claims in the Revenue Account have been shown after deduction of re-insurance.

(vi) Obtain confirmation of balances in the accounts of the re-insurers and the ceding companies.

Question 3

Enumerate the steps to be taken by an auditor for the verification of the premium income received by a general insurance company. *(8 Marks) (Final May 2001)*

Answer

Verification of Premium Income

(1) Review the internal control procedures and its compliance. This would ensure that in respect of all risks assumed, proper cover notes are issued and that no cover note/policy is omitted. Also find out whether all the cover notes are serially numbered and also the existence of adequate internal check on issue of stamps, stationery, etc. Depending on the assurance obtained from such initial evaluation, decide the extent of substantive checking to be carried out.

(2) Ensure that all premiums in respect of risks incepting during the relevant accounting year has been accounted as the premium income of that year.

(3) Verify the premium received and recorded during the year for fire, marine, motor and miscellaneous insurance business in the relevant books of account.

(4) Check that in respect of risks commencing after the year end, where the premium is received in advance, the same has been shown as "Premium Received in Advance" and see whether the similar advance of last year is accounted this year as income.

(5) Ensure that the company is not at risk in case policy documents have not been issued for any reason like dishonour of cheque and ensure that the risk has not commenced.

(6) Ensure that the company is not under risk in respect of amounts lying at credit and outstanding at the year end by verification and also obtaining a confirmation from the manager to that effect.

(7) Check whether the premium collected is recorded at gross figure without providing for unexpired risks and reinsurance.

(8) Verify that in case of co-insurance, the company's share of premium have been properly booked in the books of account in case the risk has commenced.

Question 4

In the context of audit of general insurance business, state the provisions regarding management expenses. *(8 Marks) (Final Nov 2001)*

Answer

Provisions regarding Management Expenses: Section 40C of the Insurance Act, 1938 read with Rule 17E lays down the provisions regarding limit on expenses of management in general insurance business. It requires that no insurer shall, in respect of any class of general insurance business transacted by him in India, spend in any calendar year as expenses of management including commission or remuneration for procuring business an amount in excess of the prescribed limits and in prescribing any such limits regard shall be had to the size and age of the insurer. However, any excessive amount over the permissible limits may be approved by the Insurance Regulatory Development Authority after consultation with the Executive Committee of the General Insurance Companies. Further every insurer as aforesaid shall incorporate in the revenue account a certificate signed by the Chairman and two directors and by the principal officer of the insurer, and by an auditor certifying that all expenses of management wherever incurred, whether directly or indirectly, in respect of the business referred to in this section, have been fully debited in the revenue account as expenses. Such expenses mean all charges, wherever incurred whether directly or indirectly, including commission payments of all kinds and, in the case of an insurer having his principal place of business outside India, a proper share of head office expenses, which shall not be less than such percentage as may be prescribed, of his gross premium income (that is to say, the premium income without taking into account premiums or re-insurance ceded or accepted) written direct in India during the year, but in computing the expenses of management in India the following, and only the following, expenses may be excluded, namely:

(i) In the case of an insurer who has his principal place of business in India, a share of head office expenses in respect of general insurance business transacted by him outside India not exceeding a prescribed percentage of his gross direct premium written outside India.

(ii) Any expenses debited to the profit and loss account relating exclusively to the management of capital and dealings with shareholders and a proper share of managerial expenses calculated in the prescribed manner.

Rules 17E of the Insurance Rules, 1939 deals with the computation and limitation of expenses of management in general insurance business.

Question 5

Answer the following:

Describe the audit procedures to be followed for verification of premiums by a statutory auditor of a general insurance company. *(8 Marks) (Final Nov 2002)*

Answer

Verification of Premiums: In the audit of a general insurance company, verification of premium is one of the most important aspects for the statutory auditor. The following procedure should normally be applied for verification of premium:

(i) Ascertain that all the cover notes relating to the risks assumed have been serially numbered for each class of business.

(ii) Ensure that the premium in respect of risks starting during the relevant accounting year has been accounted as premium income of that year but pertaining to risk commencing in the following year has been accounted as "Premium Received in Advance".

(iii) Verify the collections lodged by the agents after the balance sheet date to see whether any collection pertains to risk commencing for the year under audit. The auditor should also check that the premium has been recorded originally at the gross figure without providing for unexpired risks and re insurances.

(iv) In case of co-insurance business, the auditor should see that the company's share of premium has been accounted for on the basis of the available information on nature of risk and the provisional premium charged by the leading insurer.

(v) Check whether premium register have been maintained chronologically, for each underwriting department, giving full particulars including service tax charged as per acceptance advise on the day to day basis.

(vi) Verify the year-end transactions to check that the amounts received during the year in respect of risks commencing or installments falling due on or after the first day of the next financial year are not credited to premium account but to Premium Received in Advance Account.

(vii) Verify the collections remitted by the agents after the cut-off date to verify the risks assumed during the year for those collections. If the premium originally received has been refunded, the auditor should verify whether the agency commission paid on such premium has been recovered from the agent.

Question 6

Enumerate the steps to be taken by an auditor for the verification of Re-insurance outward by a General Insurance Company. *(8 Marks) (Final November 2003)*

Answer

Verification of Re-insurance outward

1. Verify that re-insurance underwriting returns received from the operating units regarding premium, claims, paid, outstanding claims, tally with the audited figures of premium claims paid and outstanding claims.
2. Check whether the pattern of re-insurance underwriting for outward cessions fits within the parameters and guidelines applicable to the relevant year.
3. Check whether cessions have been made as per the stipulation applicable to various categories of risk.
4. Verify whether the cessions have been made as per the agreements entered into with the various companies.
5. See whether the outward remittances to foreign re-insurance have been done as per the foreign exchange regulations.
6. Ascertain whether the commission has been calculated as per the terms of the agreement with the re-insurance.
7. Verify the computation of profit commission by various treaty arrangements in the figure of the periodical accounts rendered and in relation to outstanding less pertaining to the treaty.
8. Examine whether the cash loss recoveries have been claimed and accounted on a regular basis.

9. Verify whether the claims paid items appearing outstanding claims list by ever. This can be verified at least in respect of major claims.
10. See whether provisioning for outstanding losses recoverable on cessions have been confirmed by the re-insurers and in the case of major claims, documentary support was insisted and verified.
11. Accounting aspects of the re-insurance cession premium commission recoverable, paid claims recovered and outstanding losses recoverable on cessions have to be checked.
12. Check percentage pattern of gross to net premium, claim paid and outstanding claim to ensure comparative justifications.

Question 7

What are the specific areas to which you will give your attention while examining "Claims Paid" by a General Insurance Company. (8 Marks) (Final May 2004)

Answer

Examination of claims paid: The following specific areas need to be given attention while examining 'claims paid' by the general insurance company:

(i) Obtaining information from branches/divisions regarding each class of business categorising the claims value-wise.

(ii) Ascertaining the status of claims outstanding at the year-end on the basis of information available, with the company, claims for which company is liable, etc.

(iii) To verify in the case of claims paid on the basis of advices from other insurance companies whether share of premium was also received by the company. Claims communicated to other insurance companies after the year end for losses which occurred prior to the year must be accounted for in the years of audit.

(iv) Claim payments have been duly sanctioned by authority concerned and acknowledgements obtained from the recipients.

(v) Salvage recovered has been duly accounted and letter of subrogation has been obtained in accordance with the laid down procedure.

(vi) Amounts deposited with the Courts where the litigation is not completed are treated as advance/deposit and held as assets till disposal of such claims.

(vii) Past payment made against claims are duly vouched.

(viii) Ensure that the claimant has given unqualified discharge note in the case of final payment of claims.

(ix) In the case of co-insurance arrangements claims to be booked in respect of company's share and the balance has to be debited to others insurance companies.

Question 8

State the procedure for verification of Agents' Balances in the course of audit of a General Insurance Company. *(4 Marks) (Final Nov 2004)*

Answer

General Insurance Company – Verification of Agents' Balances: The following are the audit procedures for verification of outstanding agents' balances:

(i) Scrutiny and review of control accounts debit balances and their nature should be enquired into.

(ii) Examination of inoperative balances and treatment given for old balances be looked into.

(iii) Enquiring into the reasons for retaining the old balance.

(iv) Verification of old debit balances which may require provision or adjustment. Explanation be obtained from the management in this regard.

Question 9

Answer the following:

"In an audit of an insurance company, the Receipts and Payments Account is also subjected to audit". Comment on this statement in brief. *(6 Marks) (Final May 2005)*

Answer

Audit of Receipts and Payments Account: Section 11(1A) of the Insurance Act, 1938 provides that every insurer, in respect of insurance business transacted by him and in respect of his shareholders' funds, should prepare at the end of each financial year, a Balance Sheet, a Profit and Loss Account, a separate account of receipts and payments and a Revenue Account in accordance with the Regulations made by the IRDA. Since receipts and payments account has been made a part of financial statements of an insurer, it is implied that the receipts and payments account is also required to be audited.

The IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002 require that the auditor of an insurance company should:

(i) report whether the receipts and payments account of the insurer is in agreement with the books of account and returns;

(ii) express an opinion as to whether the receipts and payments account has been prepared in accordance with the provisions of the relevant statutes; and

(iii) express an opinion whether the receipts and payments account give a true and fair view of the receipts and payments of the insurer for the financial year/period under audit.

It may hence be said that auditor is required to audit the Receipts and Payments Account of the insurer and also express an opinion on the same.

Question 10

What are the steps to be taken by an auditor for the audit of re-insurance ceded?

(8 Marks)(Final Nov 2005)

Answer

Steps in Audit of Reinsurance ceded

(i) Evaluate internal control system in the area of reinsurance ceded to ensure determination of correct amount for reinsurance ceded, proper valuation of assets and liabilities arising out of reinsurance transaction and adherence to legal provisions and regulations.

(ii) Ascertain whether adequate guidelines and procedures are established with respect to obtaining reinsurance.

(iii) Reconcile reinsurance underwriting returns received from various units with the figures of premium, claims paid and outstanding claims for the company as a whole.

(iv) Examine whether commission on reinsurance ceded is as per the terms of the agreement with the re-insurers.

(v) Examine the computation of profit commission for automatic treaty arrangements in the light of the periodic accounts rendered and in relation to outstanding loss pertaining to the treaty.

(vi) Examine whether loss recoveries have been claimed and accounted on a regular basis.

(vii) Examine whether outstanding losses recoverable have been confirmed by re-insurers.

(viii) Examine whether remittances to foreign re-insurers are as per foreign exchange regulations.

(ix) Examine whether confirmations have been obtained regarding balances with re-insurers.

(x) Review individual accounts of re-insurers to evaluate whether any provision/write off or write back is required.

Question 11

Write a short note on - Solvency margin in case of an insurer carrying on general insurance business. *(4 Marks)(Final Nov 2006)*

Answer

Solvency margin in case of an insurer carrying on general insurance business: In case of an insurer carrying on general insurance business, the solvency margin should be the highest of the following amounts :

(i) fifty crore rupees (one hundred crores of rupees in case of reinsurer), or

(ii) a sum equivalent to twenty percent of the net premium income; or

(iii) a sum equivalent to thirty percent of net incurred claims.

Subject to credit for reinsurance in computing net premiums and net incurred claims being actual but a percentage, determined by the regulation but not exceeding fifty percent. It may be noted that conditions regarding maintenance of the above mentioned solvency margin may be relaxed by the authorities in certain special circumstances.

If, at any time, an insurer does not maintain the required solvency margin, the insurer is required to submit a financial plan to the authority indicating the plan of action to correct the deficiency in the solvency margin. If, on consideration of the plan, the authority finds it inadequate the insurer has to modify the financial plan.

Sub-section (2c) of Sec 64 A states that if an insurer fails to comply with the requirements of the insurance Act, 1938, it shall deemed to be insolvent and may be wound up by the court.

Question 12

State the procedure to determine the value of listed and unlisted equity securities and derivative instruments of an insurance company. *(10 Marks) (Final May 2007)*

Answer

Procedure to determine the value of listed and unlisted equity securities and derivative instruments of an insurance company : Equity securities and derivative instruments that are traded in active markets, shall be measured at fair value as at the Balance Sheet date. Fair value will be the lowest of the last quoted closing price of the stock exchanges where the securities are listed. The insurance company shall assess on each Balance Sheet date whether any impairment of listed security/derivative instruments has occurred.

An active market shall mean a market, where the securities traded are homogeneous, availability of willing buyers and sellers is normal and the prices are publicly available.

Unrealized gains/losses arising due to changes in fair value of listed equity shares and derivative instruments shall be taken to equity under the head ‘Fair Value Change Account’. The ‘profit’ on sale of investments’ or ‘loss on sale of investments’, as the case may be, shall include accumulated changes in the fair value previously recognized in equity under the heading Fair Value Change Account in respect of particular security and being recycled to profit and loss account on actual sale of that listed security.

Any credit balance in Fair Value Change Account will not be available for distribution as dividends. Also any debit balance in such an account shall be reduced from profits/free reserves while declaring dividends.

At every Balance Sheet date, impairment loss should be recognized as an expense to the extent of the difference between the re-measured fair value of the security and its acquisition cost as reduced by any previous impairment loss already recognized. Any reversal of impairment loss earlier recognized as an expense, should be recognized in the Revenue/Profit & Loss Account.

Unlisted and other than actively traded equity securities and derivative instruments will be measured at historical costs. Provision shall be made for diminution in value of such investments. The provision so made shall be reversed in subsequent periods if estimates based on external evidence show an increase in the value of investments over its carrying amount. The increased carrying amount of the investments due to reversal of the provision shall not exceed the historical cost.

Question 13

RQ Insurance Ltd. has made a provision of 25% on unexpired risks reserve in its books. Comment.
(5 Marks) (Final May 2008)

Answer

Unexpired risks reserve: The need for unexpired risks reserve arises from the fact that all policies are renewed annually except in specific cases where short period policies are issued. Since the insurers close their accounts on a particular date, not all risks under policies expire on that date.

In other words at the closing date, thee is an unexpired liability under various policies which may occur during the remaining term of the policy beyond the year end.

The minimum amount of unexpired risks reserve to be created is determined as per the Insurance Act, 1938 at a specified percentage of net premium as under:

(i) for marine hull insurance – 100% of net premium

(ii) For fire, marine cargo and miscellaneous business – 50% of net premium.

Provisions of income Tax Act, 1961 and Income Tax rules, 1962 permit deduction of above reserves at the prescribed rates.

Conclusion: In the given case, the Auditor of RQ Insurance Ltd should qualify his report as the company has made a provision of only 25% against the prescribed minimum of 50% or 100% as mentioned above, thereby resulting in overstatement of profit.

Question 14

As per the directions under Section 619(3)(A) of the Companies Act, 1956 applicable to Insurance Companies, which are the points on which the Statutory Auditor has to report on in respect of System of Accounts? *(8 Marks) (Final Nov 2008)*

Answer

System of accounting: - as per Section 619(3)(A) of the Companies Act, 1956

(1) Examine the following systems and give views as regards their deficiencies along with suggestions for remedial measures:

   (a) Recording of receipts and expenditure

   (b) Drawing periodical trial balance

   (c) Compilation of accounting.

   (d) Reconciliation of inter-office account.

   (e) Reconciliation of register/ records, relating to property, assets, investments, premiums, claims, loans etc. with financial books.

   (f) Maintenance of up to date records of assets which are pledged, encumbered or blocked in any way.

(2) Are the Bank Accounts of the company reconciled with the Bank Statement regularly? If not, describe the failures.

(3) Are control accounts and subsidiary accounts up to date and recorded regularly? If not, describe the failures.

(4) Examine the accounting policies of the company. Are these in conformity with the accounting Standards? Give particulars of material departures from these standards, if any, along with their effect on the financial statements, quantifying the impact wherever possible.

Question 15

Write a short note on - Facultative reinsurance under Insurance Act, 1938.

(4 Marks) (Final Nov 2008)

Answer

Facultative Re-Insurance

It is that type of reinsurance whereby contract relates to one particular risk and is expressed in the reinsurance policy. Each transaction has to be negotiated individually. Each party has free choice i.e., ceding company to offer and insusurer to accept. The Insurance is used when:

(i) Automatic cover has exhausted.

(ii) Risk is excluded from treaties

(iii) Reinsurance treaties have not to be over burdened for abnormal risks.

(iv) When insurer has no automatic cover.

(v) Where technical guidance is required at each stage of acceptance of risk.

NOTE

12

TAX AUDIT

Question 1

State with reasons whether an auditor conducting tax audit 'certifies' or 'reports' on information contained in the statement of particulars attached to the tax audit report under Section 44 AB of Income-tax Act, 1961. (4 Marks) (Final Nov 2000)

Answer

Section 44AB of the Income-tax Act, 1961 requires the auditor to submit the audit report in the prescribed form and setting forth prescribed particulars. The statement of particulars as required in Form 3CD (assessee carrying on a business) or Form 3CE (assessee carrying on a profession) are required to be annexed to the main audit report. The audit report is in two parts. The first part requires the auditor to give his opinion as to whether or not the accounts audited by him give a true and fair view and the second part of the report is in the form of an "Annexure" containing statement of particulars in respect of certain specified matters. The tax auditor has to report whether particulars are true and correct.

In this context, it is important to appreciate the distinction between the terms "report" and "certificate". Briefly speaking, the term "certificate" is used where the auditor verifies the accuracy of facts while the term "report" is used in case the auditor is expressing an opinion. Strictly speaking, having regard to the usage of the word true and correct, these particulars require definitive information compiled from the books of account. Hence, it can be said that an auditor conducting tax audit 'certifies" the information contained in the statement of particulars. However, having regard to the distinction, it is significant to examine whether all thirty two clauses included in the statement of particulars are capable of being simply certified on the basis of books of account or there are some clauses in respect of which different auditor(s) may hold different opinion. For instance, clause 12 dealing with valuation of closing stock would require the auditor to examine and opine on the basis adopted for ascertaining the cost and, thus, to ensure that method followed for valuation of stock results in disclosure of correct profits and gains. Similarly clause 14 relating to depreciation would require the auditor to exercise judgement having regard to the facts and circumstances of the case, etc. Thus, there are several matters on which the auditor is required to exercise judgement while giving his report on various amounts included in the statement of particulars. No doubt that the auditor obtains the statement of particulars in Form No.3CD duly authenticated by the assessee, it does not merely involve checking the corresponding figures with the documents and books of account but requires the auditor to exercise his judgement which may at times lead to different figures by different persons reporting thereon. There can also be situations leading to difference of opinion between the tax auditor and the assessee. Therefore, it can be said that an auditor conducting tax audit "reports" on certain information, apart from certifying certain factual information contained in the statement of particulars annexed to the tax audit report under section 44AB of the Income-tax Act, 1961.

Question 2

A public charitable trust earns 'income' of Rs.10 lakhs from Unit Trust of India, which is not taxable under Section 10(33) of Income-tax Act, 1961. It spends Rs.7 lakhs on its activities. The entire expenditure is vouched and is in accordance with the trust objects and is fully allowable as 'application'. As Auditor of the Trust, would you require the trust to make any provision for tax in its accounts? (4 Marks) (Final Nov 2000)

Answer

Section 10(33) of the Income-tax Act, 1961 provides exemption in respect of income received in respect of units from Unit Trust of India to all assessees including a public charitable trust. Hence, Rs.10 lakhs received from Unit Trust of India is not taxable income of the trust. The Income-tax Act, 1961 requires that for claiming full exemption by the trust, it is required to apply at least 75% of such income during the previous year for charitable or religious purposes. As per the facts given, the trust has applied only Rs.7 lakhs i.e. 70% of its total income towards the trust objects and, thus, contravened the requirements of the Act. Yet the trust shall not be required to pay tax on its income because the income has been received on account of units which in any case is fully exempt under the Income-tax Act, 1961. Accordingly, the trust is not required to make any provisions for tax in the accounts. The fact that not spending Rs.3 lakhs out of Rs.10 lakhs, though contravening the requirement of spending at least 75% of "income" would, therefore, not attract tax. Hence, no tax provision is necessary.

Note: The tabular presentation of the statement of income is given below for general information of students:

(a)	Revenue Statement: UTI Income – Exempt u/s 10(33)	Rs.10,00,000
(b)	Statement of Total Income:	
	UTI income [exempt under section 10(33)]	10,00,000
	Less: Spent on Trust's objects	7,00,000
	Amount unspent	3,00,000
	Accumulation allowable @ 25% of Rs.10,00,000	2,50,000
	Balance	50,000
	Less: Not taxable as UTI income is exempt	50,000
	Taxable Income	NIL

Question 3

Comment on the following:

(a) Mr X, who conducts the tax audit u/s 44AB of the Income-tax Act, 1961 of M/s ABC, a partnership firm has received the entire audit fees of Rs.25,000 in April, 2000 in respect of the tax audit for the year ended 31.3.2000. The audit report was however signed in September, 2000. (4 Marks)

(b) Mr P carries on the business of dealing and export of diamonds. For the year ended 31st March, 2000, you as the tax auditor, find that the entire exports are to another firm in U.S.A., which is owned by Mr P's brother. (4 Marks) (Final May 2001)

Answer

(a) Receipt of Tax Audit Fees in Advance: Under section 226(3)(d) of the Companies Act, 1956, a person is disqualified from being an auditor if he is indebted to the company for more than Rs.1,000. This provision for disqualification would apply only in case of an auditor appointed under the Companies Act, 1956. The intention of the Companies Act, 1956 is to ensure that the auditor is not under any financial obligation of the company.

When a chartered accountant is appointed to conduct a tax audit u/s 44AB of the Income Tax Act, 1961, his appointment is not under the Companies Act, 1956 but under the Income Tax Act, 1961. In the Income Tax Act, 1961 there is no such provision for a person to be disqualified on his becoming indebted to the company. Thus in the instant case, though the entire audit fees are taken in advance, Mr X would still be able to carry out the audit and he would not be disqualified. However, having regard to be professional ethics in general an auditor must avoid such situations and may consider disclosing the same.

(b) Export Payments to a Relative: Clause 18 of Form 3CD, annexed to the tax audit report in Form 3CA/3CB, requires the tax auditor to specify particulars of payments made to persons specified u/s 40(A)(2)(b) of the Income Tax Act, 1961. Persons specified in the said section are relatives of an assessee and sister concerns, etc. In the instant case, however, Mr. P has not made any payments to his brother. On the contrary, he must have received payments from him against exports made and, thus, this clause would not be applicable to him. Mr P will nonetheless be still as a part of his normal audit planning would be required to verify whether the exports are genuine, i.e., whether the diamonds have been delivered by verifying the necessary delivery documents, relevant invoices, etc., the reasonableness of the price and whether the export realisations have been received.

Alternative Solution: Clause 26 requires Section-wise details, if any, admissible under Chapter VIA of the Income Tax Act, 1961. Accordingly, the tax auditor is required to give tax audit report in respect of deduction admissible under Chapter VIA with reference to the books of account of the entity audited by him. The auditor would also have to see that whether different admissible condition under the specified section, i.e., Section 80HHC have been fulfilled or not. Under Section 80HHC, the quantum of deduction in respect of export profit is on the basis of convertible foreign exchange having been received within a period of 6 months from the end of accounting year or extended period. In this context, the tax auditor has to verify that all export proceeds have been received by the assessee by 30th September and for this he has to ask the client to produce necessary bank certificate. Further, tax auditor should also refer to separate audit report while verifying the information.

Question 4

In the context of tax audit under Section 44AB of the Income-tax Act, 1961, discuss the provisions of Section 145 of the said Act regarding the method of accounting and accounting standards notified thereunder. *(8 Marks) (Final Nov 2001)*

Answer

Accounting Standards and the Income-tax Act: As per Section 145 of the Income-tax Act, 1961 incomes chargeable under the head "Profits and Gains from Business or Profession" or "Income from other sources" has to be computed in accordance with either the cash or the mercantile system of accounting as regularly employed by the assessee. If the said system of accounting is not followed, the assessing officer has the power to reject the books of account and complete the assessment to the best of his judgement. For this purpose, the Central Government also had the power to issue accounting standards to be followed. Accordingly, the government notified two Accounting Standards, called AS(IT). These are to be followed by all assessees following the mercantile system of accounting. Those assessees who are following cash system of accounting need not follow the Accounting Standards. These AS(IT) notified were:

AS(IT)–1	Disclosure of Accounting Policies
AS(IT)–2	Disclosure of Prior period and Extraordinary Items and Disclosure of Accounting Policies.

Section 145 provides that the AS(IT) notified under that section should be followed by the assessees to whom they are made applicable. It should be noted that the tax auditor auditing accounts under section 44AB is not computing the income but is – (a) reporting on accounts, and (b) reporting on the relevant information furnished in Form No.3CD. Now, the revised Form No.3CD vide cause 11(d) requires reporting of the details of deviation, if any, in the method of accounting employed in the previous year from accounting standards prescribed under section 145 and the effect thereof on the profit or loss. Further, it may be noted that there is no material difference between AS(IT)-1 and AS(IT)-2 notified by the Government and the corresponding AS 1 and AS 5 of the ICAI respectively.

Question 5

A leading jewellery merchant used to value his inventory at cost on LIFO basis. However, for the current year, in view of requirements of AS 2, he changed over to FIFO method of valuation. The difference in value of stock amounted to Rs.55 lakhs which is higher than that *under the previous method. In such a situation, what are the reporting responsibilities of a Tax Audit under Section 44AB of Income Tax Act, 1961 (7 Marks) (Final May 2002)*

Answer

The change in the method of valuation of stock is not a change in method of accounting, as it is only a change in accounting policy. However in the Income Tax Act, 1961 this is considered under method of accounting. Under the Income-Tax Act, 1961 if the change in method of valuation is bonafide, and is regularly and consistently adopted in the subsequent years as well, such change would be permitted to be made for tax purposes. In the instant case, the change in the valuation of stock from LIFO basis to FIFO basis is pursuant to mandatory requirements of the AS 2 'Valuation of Inventories' and therefore should be viewed as bonafide change.

This apart, the tax auditor in his report has to specifically refer to the method of valuation of stock under Clause 12 in Form 3CD.

(a) Method of valuation of closing stock employed in the previous year.

(b) Details of deviation, if any, from the method of valuation prescribed under section 145A and the effect thereof on profit or loss.

The auditor has to see that the method of stock valuation is followed consistency from year to year. It is also necessary to ensure that method followed for valuation of stock results is correct profits or gain 2001. The change from LIFO to FIFO is bonafide, the disclosure of which would have to be made the financial statements. As far as section 145A is concerned, the tax auditor need not change the method of valuation of purchases, sales and inventories which is regularly employed by the assessee. All that he has to do is to adjust the valuation for any tax, duty, cess or fee actually paid or incurred by the assessee, if the same had not already been adjusted.

Question 6

XYZ Private Limited is engaged in the wholesale business of buying and selling silk sarees. The accounts are maintained under the Companies Act from 1st October to 30th September each year. The Chief Accountant of the Company is requesting the tax auditor to conduct tax audit U/S 44AB of the I.T. Act for the period for which accounts have been maintained under the Companies Act. As the tax auditor of XYZ Private Limited, how will you react to the Chief Accountant's request? (8 Marks) (Final May 2003)

Answer

Accounting Period under Section 44AB: In relation to the question as to whether u/s 44AB the tax auditor can audit and certify the amounts for the period for which accounts have been maintained under the Companies Act (in this case from October to September) or whether the tax auditor will have to certify the accounts for the relevant financial year which is the uniform accounting year for tax purposes, the CBDT have considered the matter and are of the opinion that as the income of the previous year is chargeable to tax and for the purposes of Income tax Act, the previous year is the financial year, the tax auditor would have to carry out the audit u/s 44AB in respect of the period covered by the previous year i.e., the relevant financial year. The proviso for the aforesaid section 44AB, therefore, covers only the cases where the accounts are audited under any other law in respect of the financial year. Where the accounting year is different from the financial year, the proviso to section 44AB will not apply. Consequently the tax auditors would have to carry out the tax audit in respect of the period covered by the relevant financial year and submit has report Form 3CB, as required in rule 6G(I) (b) of the I.T. Rules (Circular No. 561. dated 22.5.90).

Question 7

As a tax auditor, which are the accounting ratios required to be mentioned in the report in case of manufacturing entities? Explain in detail any one of the above ratios and how does it help the tax auditor in his analytical review. *(8 Marks)(Final Nov 2005)*

Answer

The ratios which are to be calculated for manufacturing entities are:

- Gross profit / Turnover
- Net Profit / Turnover
- Stock-in-trade/Turnover
- Material consumed / Finished goods provided

Ratio analysis constitutes a substantive auditing procedure designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. Such assessment is necessary in organisation having large volumes of transactions and in the organisation following mechanised accounting system where it is not possible to check each and every transaction. It has the merit of bringing to focus the abnormal deviations and unexpected variations which the normal routine checking in auditing may fall to reveal. Ratios highlight only symptoms and that too as of a particular day and the auditor should study these symptoms properly, correlate them and reach definite conclusions or identify areas for further enquiries. The auditor should by relating sales with the net profit, various items of direct and indirect costs and gross profit gather information about the profitability and operating efficiency of an enterprise; variations in any of these ratios in a particular year should be inquired by the auditor. The fall in the gross profit ratio and profitability ratio should alert the auditor who should ask the management for the reasons thereof and which should be carefully examined by him. The auditor should by relating sales with the net profit, various items of direct and indirect costs and gross profit gather information about the profitability and operating efficiency of an enterprise; variations in any of these ratios in a particular year should be inquired by the auditor. The fall in the gross profit ratio and profitability ratio should alert the auditor who should ask the management for the reasons thereof and which should be carefully examined by him.

These ratios have to be given for the business as a whole and not product wise. While calculating these ratios, the tax auditor should assign a meaning to the terms used in the above ratios having due regard to the generally accepted accounting principles all the ratios mentioned in the clause are to be calculated in terms of value only.

The relationship of stock-in-trade to turnover over a period of time would reveal whether the entity has been accumulating stocks or there is a decline in the same. The auditor may obtain data for about 7-10 years, compute ratio of stock-in-trade/turnover and plot it on a graph paper over a period of time. This may give rise to several possibilities such as parallel horizontal lines, vertical rising line or a vertical falling line. A study of this relationship would reveal whether stocks are being accumulated or they are dwindling over a period. Such an information would provide an input to tax auditor as to whether figures of either stock or turnover are being manipulated. Sometimes, while studying the relationship, it may show sudden decline or increase at a point of time would reflect that there is definitely something wrong with the figures of stock. Therefore, a close examination of such ratios helps the tax auditor to focus on major deviations and consequently reasons for the same.

Question 8

Write short notes on the following:

(a) Recognition of Deferred Tax Assets *(Final Nov 2005)*

(b) Deferred Taxation *(4X2=8 Marks) (Final May 2006)*

Answer

(a) Recognition of Deferred Tax Assets: Deferred Tax Assets (DTA) are to be recognised as laid down by AS 22 "Accounting for Taxes on Income" a DTA arises on account of a timing difference in which the taxable income is more than the book income. A deferred tax asset (and the corresponding tax saving) should be recognised only after applying the test of prudence. Thus, where the enterprise does not have unabsorbed depreciation and carried forward losses as per the tax laws, deferred tax assets should be recognised and carried forward to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realized. In other words, no deferred tax asset should be created if there is no reasonable certainty about the requisite future taxable income. The existence or absence of a reasonable level of certainty would normally be determined by examining the past record of the reasonable and by making realistic estimates of profits for the future.

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

ICAI has stated that virtual certainty refers to the extent of certainty which, for all practical purposes, can be considered certain. Determination of virtual certainty of availability of sufficient future taxable income is a matter of judgement which will have to be made on a case-to-case basis.

(b) **Deferred Taxation:** AS 22, Accounting for Taxes on Income, prescribes the accounting treatment for taxes on income. The amount of taxable income for a period and the amount of profit (or loss) as shown by the profit and loss account for that period are seldom the same. The difference between accounting income and taxable income arise due to the fact that taxable income is calculated in accordance with tax laws whose requirements regarding computation of taxable income differ from the accounting policies applied to determine accounting income. The difference between taxable income and accounting income can be classified into 'permanent differences' and 'timing differences'. 'Permanent differences' are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently. Timing differences, on the other hand, are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. The standard requires that deferred tax should be recognized for all timing differences, subject to the consideration of prudence in respect of deferred tax assets. Deferred tax represents the future tax effects of timing differences. Some timing differences are such that their reversal in future year(s) would result in the taxable income for the year(s) of reversal being higher than the accounting income for that year (or those years).

Question 9

As a tax auditor, how would you report on the following:

(i) Labour charges paid on which tax is deducted at source at an inappropriate rate.

(4 Marks)

(ii) Capital expenditure incurred for Scientific Research Assets. (4 Marks)(Final May 2006)

Answer

(i) Section 40(a) of the Income-tax Act, 1961 specifies that amounts payable to a contractor or sub-contractor, being resident, for carrying out any work (including supply or labour for carrying out any work) on which tax is deductible under Chapter XVII-B and such tax has not been deducted or after deduction has not been paid during the previous year or in the subsequent year before the expiry of the time prescribed under sub-section (1) of section 200, shall not be deducted in computing the income. Therefore, if tax is deducted at an inappropriate rate, the amount is disallowable u/s 40(a)(ia) of the Income-tax Act. This fact needs to be reported in Clause 17(f) of Form 3CD where all amounts inadmissible u/s 40(a) are to be reported. In case, the assessee submits that the rate is proper, though in the auditor's view it is improper, the tax auditor should exercise his judgement and accordingly report in Clause 17(f) of Form 3CD.

(ii) Clauses 15(a) and (b) of Form 3CD requires that expenditure on Scientific Research (capital as well as revenue) covered u/s 35 of the Income-tax Act, 1961 reported of the amount debited to the profit and loss account (showing the amount debited and deduction allowable and not debited to the profit and loss account. Accordingly, the auditor should exercise his judgement and accordingly report in Clause 15(b) the amount of capital expenditure not debited to the Profit and Loss Account which is eligible for deduction u/s 25 as Scientific Research Expenditure.

Question 10

Write a short note on - Method of accounting in Form No. 3CD of Tax Audit.

(4 Marks) (Final May 2007)

Answer

Method of accounting in Form No. 3CD of Tax Audit: Clause 11 of Form No. 3CD of the tax audit requires to state method of accounting employed in the previous year. It also requires to state change in method of accounting vis-à-vis the preceding year. If so, details of change and the effect on the profit or loss are to be stated. Also details of deviation thereof if any, from accounting standards prescribed under section 145 and the effect thereof on the profit or loss are stated.

Section 145 provide that method of accounting be either cash or mercantile. Hybrid system is not permitted.

Question 11

What are the steps for the Audit under the State level 'Value Added Tax' (VAT)?

(8 Marks) (Final Nov 2007)

Answer

VAT is a tax on the value added to the commodity at each stage in the production and distribution chain. VAT is an indirect Tax on consumption. It is a tax on the value at the retail point of sale which is collected at each stage of sale.

The essence of VAT is that it provides credit set off for input tax i.e. tax paid on purchases against the output tax i.e. tax payable on sales.

The following steps have to be taken by the auditors while auditing under VAT.

(i) ***Knowledge of Business****:* The Auditor should familiarize himself with the business of the Auditee.

(ii) ***Knowledge about VAT Law and Allied Laws****:* The Auditor should study the VAT Law particularly definitions, procedures to be adopted, provision regarding issues of invoices, claiming of input tax credit etc.

(iii) ***Major Accounting Policies****:* The Auditor should ascertainable major accounting policies with regard to sales purchases and valuation of inventory.

(iv) ***Accounting Records maintained by Auditee****:* The auditor should obtain a complete list of all the accounting records relating to sales/purchase of goods, stock, various registers ledgers etc, maintained in which, the transactions are recorded.

(v) ***Evaluation of Internal control**:* The Auditor should evaluate the internal controls prevalent in the entity with respect to sales, Purchases, Production and Accounting. He must examine the adequacy and effectiveness of the controls in order to plan the nature and timing of his audit procedures.

The following provisions of VAT need to be understood:

- Credit for inputs/supplies (and its accounting).
- Credit in case of capital goods.
- Utilising VAT credit for set off.
- Valuation of inventories/capital goods.
- Credit for goods lying in stock at inception of VAT scheme.
- VAT on sales.

Question 12

Write a short note on - Accounting ratios in Form 3 CD of Tax Audit.

(4 Marks) (Final Nov 2007)

Answer

Accounting Ratios in Form 3CD of Tax Audit

(i) Gross Profit/Turnover.

(ii) Net Profit/Turnover.

(iii) Stock in Trade/Turnover.

(iv) Material consumed/finished goods produced.

These ratios have be calculated only for assessees who are engaged in manufacturing or trading activities. This clause is not applicable to assessees carrying on profession. Moreover, the ratios have to be given for the business as a whole and need not be given product wise. Further, the ratio mentioned in sub-clause (d) need not be given for trading concern.

Question 13

Answer the following

As the tax auditor of a Company, how would you report on payments exceeding Rs 20,000 made in cash to a supplier against an invoice for expenses booked in an earlier year?

(5 Marks) (Final May 2008)

Answer

Reporting of payments exceeding Rs. 20,000 in cash: Such reporting is required to be done while conducting the tax audit u/s 44AB of the Income Tax Act, 1961 in Form 3CD with effect from A. Y. 2008-09. The tax auditor shall have to report for clause 17 (h) for the above as per the amended section 40 A(3) of the Income Tax Act, 1961.

In the instant case the invoice for expenses has been booked in an earlier year. However, since payment for the same is made during the current year by cash exceeding Rs. 20,000, the reporting thereof would be necessary in clause 17(h) of Form 3CD. *The sub-clause (h) required furnishing of the amount inadmissible under section 40A(3) read with rule 6 DD along with computation.*

The entire amount paid as above, is likely to be disallowed u/s 40 A(3) of the Income Tax Act, 1961.

Question 14

Discuss the reporting requirement in Form 3CD of Tax Audit Report under Section 44AB of the Income-tax Act, 1961 for the following:

(i) Tax deducted at source.

(ii) Expenditure incurred at clubs. *(8 Marks) (Final Nov 2008)*

Answer

(i) Under clause 27, following particulars as to tax deduction has to be furnished in Form 3CD as under:

(a) Whether assesee has deducted tax at source and paid the amount so deducted to the credit of Central Government in accordance with provisions of Chapter XVII-B.

(b) If answer to (a) above is negative, then the following details

S. No.	Particular	Head under which tax is deducted at source	Amount of TDS (Rs.)	Due Date of Remittance	Details of Payment	Remark

In case test checking has been done for the above (in case of voluminous data) an appropriate disclosure for the same is to be given.

(ii) Reporting for expenditure incurred at clubs is to be given as per clause 17(d) of Form 3CD. The following details are required:

- Amount debited to Profit & Loss account for:
- Expenditure incurred at Clubs:
- As entrance fees and subscription.
- As cost for club services and facilities used.

The above is to be given for directors, partners, employees and others. If the expenses are personal in nature, reporting is also required in clause 17(b).

NOTE

13

AUDIT OF MEMBERS OF STOCK EXCHANGE

Question 1

How is an auditor concerned under the guidelines issued by Securities and Exchange Board of India relating to the following matters, while certifying financial information included in offer documents?

(i) Transactions with companies in promoter group

(ii) Bifurcated turnover

(iii) Return on net worth

(iv) Price earning ratio *(8 Marks) (Final Nov 2000)*

Answer

As per the SEBI (Disclosure and Investor Protection) Guidelines 2000, an auditor is required to report on the financial information to be included in the offer documents. The above four items form part of such information.

(i) **Transactions with companies in promoter group:** Disclosure is required to be made in the offer document in respect of the following:

  (a) Sales or purchase between companies in the promoter group when such sales or purchases exceed in value in the aggregate 10% of the total sales or purchases of the issuer; and

  (b) Material items of income or expenditure arising out of transactions in the promoter group. (*Sub Para 3.5 of Para 10 of Chapter VI*).

  The aforesaid information is required to be given by the auditor of the issuer company in his report for inclusion in the offer documents.

(ii) **Bifurcated Turnover:** The turnover disclosed in the profit and loss statement shall be bifurcated into:

  (a) turnover of products manufactured by the company;

  (b) turnover of the products traded in by the company; and

  (c) details of products not normally dealt in by the company but included in (b) above are required to be mentioned separately. (*Clause c of Sub Para 2.7 of Para 10 of Chapter VI*).

(iii) **Return on Net Worth:** Clause (f) of Sub Para 2.7 of Para 10 of Chapter VI requires that the offer document to include certain accounting ratios for each of the accounting periods for which information is given. Return on net worth is one of such accounting ratios. This ratio is computed by using the following formula:

$$\frac{\text{Net Profit before extraordinary items but after adjusted tax}}{\text{Net worth excluding revaluation reserve as at the end of the year}} \times 100$$

In the above formula the adjusted tax means the provision for taxation for the period after adjusting tax attributable to extraordinary items. The above forms part of the other financial information required to be included by the management and which should be reported upon the company's auditor by way of separate report to management. The management is required to get this information audited by the company's auditor and obtain an audit report in respect thereof.

(iv) **Price Earning Ratio**: Clause (a) of Sub Para 4.11 of Para 8 of Chapter VI under the heading 'Basis for Issue Price' requires disclosure of P/E pre-issue and comparison thereof with industry P/E where available (giving the source from which industry P/E has been taken). The pre-issue price / earnings ratio should be calculated by using the following formula:

$$\frac{\text{Issue price per share}}{\text{Earning per share}} \times 100$$

Earning per share is to be disclosed as per Part A-I of clarification XIV is the EPS after taking into account all outstanding conversions and options i.e. diluted earning per share. The auditor should satisfy that the calculations have been made accordingly.

Question 2

Write short notes on the following:

(a) Rolling Settlements

(b) Carry Forward System *(4x2=8 Marks) (Final May 2000)*

Answer

(a) Rolling Settlements: A rolling settlement is one in which trades outstanding at the end of the day have to be settled (payments made for purchases or deliveries in the case of sale of securities) at the end of the settlement period. Rolling settlement was first introduced at the Over the Counter Exchange of India (OTCEI) on a T + 3 basis. The NSE has introduced rolling settlement in its demat segment on a T + 5 basis on July 9, 1997. From January 15, 1998, SEBI has made it compulsory to settle all trades in the demat segment of exchanges for all shares compulsorily on a T + 5 basis. In rolling settlements, payments are quicker than in the weekly settlements. Thus, investors benefit from the increased liquidity. For example, in a rolling settlement system, investors would receive the payments on the fifth day after the sale. For rolling settlement to be successful, three essential prerequisites are: (1) electronic trading of shares (2) equity derivatives, and (3) stock lending and borrowing schemes. While rolling settlement is technically possible with physical certificates, the infrastructure required is not forthcoming. At the stock exchange level, rolling settlement with physical certificates would involve daily pay-in, pay-out, daily auction, withdrawal, and deposits of scrips. Further, all settlements including for short delivery, delivery objections, etc. will have to be executed on daily basis. The introduction of rolling settlement would, most probably, result in the demise of the badla system. The SEBI recently discussed the proposal of the introduction of Carry Forward in Rolling Settlement and approved the introduction of Carry Forward System in the Rolling Settlement as proposed by the Varma Committee, i.e., both the daily and weekly carry forward system with maturities of 1, 2, 3,4 and 5 days.

(b) **Carry forward System:** Carry forward System was in operation since January, 1996, on the basis of rules developed by the SEBI. It provides features to carry forward the transaction in case of 'A' group scrips. The system permits break-up of transaction quantities into those for delivery and those for carry forward. Members are classified-in two categories viz. Type I and Type II. Type I members are allowed to carry forward their position while others are not allowed to do so. Carry forward transactions take place on Saturdays for the Monday to Friday settlement cycle.

Carry forward trading was evolved in response to local needs in India and it refers to the trading in which the settlement is postponed to the next account period on payment of contango charges (known as 'vyaj badla') In which the buyer pays interest on borrowed funds or the backwardation charges (known as : ' Ultta badla ') in which the short seller pays a charge for borrowing securities.

Thereafter SEBI recently introduced changes in the existing Carry Forward System under the weekly account period settlement:

(i) Increase in the carry forward limit per broker from the existing limit of Rs.20 crores to Rs.40 crores. The margin up to the present limit of 20 crores will remain at the present level of 15% and the incremental position will attract a minimum margin of 20%. Further, there will be scrip wise broker wise position limit, which presently will be Rs.5 crores.

(ii) To continue the margin on carry forward trades on gross basis. The introduction of margin on gross basis in the cash market as well as the incorporation of client code will b considered separately by the Risk Management Group constituted by SEBI.

(iii) To discontinue the present limit of 75 days for carrying forward trades.

(iv) To introduce specific eligibility criteria for scrips in the carry forward system both in the account period and rolling settlement as well as for scrips in the continuous not settlement.

Presently this system is not in operation.

Question 3

Write a short note on - Hit or take orders. *(4 Marks) (Final May 2002)*

Answer

Hit or Take Orders: Hit or take orders occur in screen-based trading in stock exchange. This is a variation of market orders. It allows for faster order execution without cluttering up the limit order book. This method converts the key strokes or mouse clicks of the broker into a limit order at the touch line price for a particular scrip, without his having to place a limit order. Further all unexecuted orders of this type are automatically killed and are therefore not stored in the order book.

A broker interested in a particular scrip would ask the system to display the touch line of that scrip. He would then operate certain predefined keys or mouse clicks which would be different for buy and sell orders. The system would ask the broker to identify the client (may be skipped) and to quantify the order. The system, would then convert his buy or sell order for the quantity specified into a limit order and attach the touchline offer price for a buy order or a touchline bid price for a sell order. This order will be matched against jobber quotes and the order book for the quantity can be executed. The unexecuted quantity, if any, will be killed and removed from the system.

Question 4

Write a short note on - Contract notes. *(4 Marks) (Final Nov 2003)*

Answer

Contract Notes: Contract note is a document through which a contractual obligation is established between a member and a client. The auditor should verify that the transactions done by a member are recorded in the *sauda book*. It should also be examined that contract notes are issued for all the business conducted on behalf of the client. The auditor should verify the list of traders executed with the bills raised. The auditor should apply appropriate audit procedures to satisfy himself that:

(i) Contract notes have been serially numbered

(ii) No serial number has been left blank.

(iii) Format of the contract note is as prescribed by the Regulations of the exchange.

(iv) Duplicates copies/counter foils of contract are maintained.

(v) Brokerage charged in contract notes is within the permissible limits and is indicated separately including service tax.

(vi) Contract notes have been issued in respect of all transactions and signed by an authorised person.

(vii) Transaction identification, trade identification and trade execution time has been printed on the contract note issued.

(viii) SEBI Regulation number, settlement number and settlement dates have been mentioned.

(ix) PAN number of the member and client has been mentioned on contract note, if required.

(x) All clauses specified by the exchange have been printed on the reverse of the contract notes.

Question 5

Write a short explanatory note on - Rolling Settlement. *(4 Marks)(Final May 2004)*

Answer

Rolling Settlement: A rolling settlement is one in which a transaction outstanding at the end of the day have to be settled within X number of business days from the transaction date. If a transaction is entered on Monday on T+2 rolling settlement, it will be settled on Wednesday when pay in or payout take place. SEBI has mandated most of the scrips to be settled exclusively on rolling settlement basis. Value at Risk (VaR) based margin approach has been adopted for transactions done in Compulsory Rolling Settlement. In the VaR system of margin, historical volatilities of scrips and overall market volatility is considered to arrive at a VaR margin percentage for a scrip. If a member fails to deliver the shares sold in rolling settlement, the exchange conducts an auction session to meet the shortfall credited by non-delivery of shares. If the auction price / close out price is less than the sale price, the difference is credited to Investor's Education and Protection Fund. If the sale price is less than the auction price / close out price, the difference is payable by the defaulters.

Question 6

Write a short note on - Sauda Book. *(4 Marks)* (*Final Nov 2004)*

Answer

Sauda Book: All members of a stock exchange are required to maintain a 'Sauda Book', which contains details of all deals transacted by them on a day to day basis. This is a basic record, which each member is required to maintain regularly on day-to-day basis. It contains the details regarding the name of the code of the client on whose behalf the deals have been done, rate and quantity of bought or sold. These details are maintained date-wise. This register contains all the transactions, which may be of any of the kind mentioned below :

- member's own business on the Exchange,
- member's business on the Exchange on behalf of clients,
- member's business with the clients on principal-to-principal basis,
- member's business with the members of other Stock Exchanges,
- member's business on behalf of his clients with the members of other Stock Exchanges, and
- spot transactions, etc.

Question 7

Write a short note on - Margins (Under Stock Exchange Trading Regulations).

(4 Marks) (Final May 2005)

Answer

Margins: Margin refers to deposit made by members with the stock exchange authorities. There can be wide fluctuations at the time of settlement in the prices of securities since the closing rate of the earlier settlement. In order to restrict excessive speculation and also to safeguard the interest of the investors, members are required to keep certain deposits with the stock exchange. The members are required to collect the margin from their clients and deposit the same with clearing house. Margin is intended to protect the members by providing them with funds to cover anticipated fluctuations in prices of securities, particularly, if the client delays or is unable to meet his commitments. It also helps prevent excessive speculation, as clients would be required to invest some funds and not indulge in speculations without adequate resource. Different type of margins which a member is normally required to deposit are: Gross exposure margin, Mark to market margin, Volatility margin, 'Additional Volatility margin, Special margin and Ad-hoc margin etc. These margins are required to be paid on due dates at stipulated time as decided by the exchange or clearing house of the exchange. The members are required to compute margin payable for all the securities traded by them.

Question 8

Write short notes on the following:

(a) Contract Notes (Under Stock Exchange Trading Regulations) (4 Marks)(Final Nov 2005)

(b) Types of market under NEAT (National Exchange Automated Trading).

(4 Marks)(Final Nov 2006)

Answer

(a) Contract Notes (Under Stock Exchange Trading Regulations): Contract note is a document through which a contractual obligation is established between a member and a client. Every member of the stock-exchange has to issue contract notes to his clients for the trades executed on their behalf. The auditor should apply appropriate audit procedure to satisfy himself that:

- Contract notes have been serially numbered
- No serial number has been left blank
- Format is as prescribed by the regulations on the exchange
- Duplicate copies /counterfoils of contract notes are maintained
- Brokerage charged in contract notes is within the permissible limits and is indicated separately including service tax
- It is signed by an authorised person
- It has been issued in respect of all transactions

- Transaction identification trade identification and trade execution time has been printed on the contract note issued
- SEBI Registration No., Settlement No., Settlement Dates have been mentioned
- PAN No. of the member and client has been mentioned on contract note where if required
- All clauses specified by the Exchange have been printed on the reverse of the contract notes.

(b) Type of markets under NEAT

(i) **Normal Market**: All orders of regular lot size or multiples thereof are traded in the normal market. Normal market consists of regular lot orders, special term orders, negotiated trade order and stop loss order depending on their order tributes.

(ii) **Odd Lot Market**: If the order size is less than the regular lot size such orders are traded in the odd lot market. In an odd lot market both the price and quantity of both the orders (buy and sell) should exactly match for the trade to take place.

(iii) **Spot Market**: Spot orders are similar to normal market orders except that spot orders have different settlement periods vis-a-vis normal market.

(iv) **Auction Market**: In the auction market, auctions are initiated by the exchange on behalf of trading members, for completing the settlement process.

Question 9

State the items contained in the SEBI's check list for auditors in respect of contract notes issued by a Stock Broker. *(8 Marks) (Final May 2007)*

Answer

SEBI's check list for auditors in respect of contract notes issued by a Stock Broker

(1) Members should issue Contract Notes to his clients for all trades executed by him on their behalf.

(2) The member should stamp his order sheets/records and the order time should be reflected in the Contract Note along with the time of execution of order.

(3) The Contract Notes should bear SEBI Registration number of the member. If should be pre printed and issued within 24 hours of trade execution. Appropriate stamps should be affixed on the contract Note. Duplicate copies of the contract note should be maintained.

(4) The Contract Note should be signed by the member or his constituted attorney.

(5) Contract note issued to the clients should show the brokerage separately .

(6) In case the broker acts as a principal, the Contract Note should be in Form B.

(7) Consent of the client should be taken for any trade done by the broker while acting as a principal.

(8) Brokerage should be within the limits prescribed by the exchange.

Question 10

Write a short note on - Circuit Filters (as specified by SEBI) (4 Marks) (Final Nov 2007)

Answer

Circuit Filters: Circuit breakers or filters are the price bonds that set the upper and lower limit within which a stock can fluctuate on any particular day. A price band for a day is a function of previous trading days' closing. SEBI has directed exchanges to apply circuit filters on scrips traded in rolling settlement if their price fluctuates more than 20% of the closing price of scrips on the previous day in any direction. However for scrips forming part of Sensex or in which derivatives and futures are available, the fluctuation is restricted to 10%.

Question 11

In the context of Audit of members of Stock Exchanges, explain what is Rolling Settlement?

(5 Marks) (Final May 2008)

Answer

Rolling settlement: A rolling settlement is one in which trades outstanding at the end of the day have to be settled (payments made for purchases or deliveries in the case of sale of securities) within 'X' business days from the transaction date.

In the rolling settlement, trades on each single day are settled separately from the trades done earlier or subsequent trade days. The netting of trades is done only for the day and not for multiple days.

SEBI has gradually mandated most of the scrips to be settled exclusively on Rolling Settlement basis [T+2]. Thus, in a T+2 rolling settlement, a transaction entered into on Monday, for instance, will be settled on Wednesday when the pay-in or pay-out takes place. The transaction in the Compulsory Rolling Settlement (CRS) are settled on T+2 basis i.e. both pay in and pay out of monies and securities for transactions in scrips on transaction day (T-Day) would take place on the day after immediately following day.

However, transactions in 'Z' group securities are settled only on trade to trade basis on T+2, i.e. the facility of netting up of buy and sell transactions of the same day, as available in other securities, is not available with securities falling under 'Z' group. In other words, if the investor buys and sells X number of shares on the same day , then he shall first have to actually deliver and then receive the securities on the settlement day.

Value at Risk (VaR) based margining approach has been adopted for transactions done in CRS scrips w.e.f. July 2, 2001. In the VaR system of margining, historical volatilities of scrips and overall market volatility is considered to arrive at a VaR margin percentage for a scrip. Further the mark-to-market difference are collected on a daily basis and the broker members are required to maintain a capital level, as prescribed by the exchange, adequate to support their exposure at all times.

In case, a member fails to deliver the shares sold in rolling settlement, the exchange conducts an auction session on T+2, to meet the shortfall created by non-delivery of shares. In this auction session, offers are invited from the other members to deliver the shares sold by originally selling member, since delivery has to be made to the buying member. In case no shares are received in auction, the sale transaction is closed-out at a close-out price, determined by higher of the following:

- Highest price, recorded in the scrip from the settlement in which the transaction took place upto a day prior to the auction OR
- 20% above the closing price on a day prior to the auction.

In this case, the auction price/ close-out and difference between sale price, if positive is payable by the seller who failed to deliver the scrips. In case, auction/ close out price is less than sale price, the difference is not given to the seller, but is credited to investor protection fund.

Question 12

Write a short note on - Securities Transaction Tax. *(4 Marks) (Final May 2008)*

Answer

Security Transaction Tax (STT): In the union budget for 2004-05, Government has introduced Security Transaction Tax to be levied on all transactions done on stock exchanges. As per the provisions of the Finance Bill the stock exchanges have been entrusted with the responsibility of levy, collection and remittance of the STT on all transactions from the date of notification by the Government of India.

SEBI vide its Circular no. MRD / DOP /Cir – 28 / 2004 dated August 23, 2004 directed that no stock exchange shall permit trading activities unless it implements necessary software and procedures for the levy, collection and remittance of STT.

NOTE

14

SPECIAL ASPECTS

Question 1

An auditor of a Cooperative Society governed by Cooperative Societies Act, 1912 is required to attach schedules giving certain information. Please list the information required to be given in the schedules. *(8 Marks) (Final Nov 2000)*

Answer

Section 17 of the Co-operative Societies Act, 1912 specifically requires the auditor to conduct an examination of the overdue debts, if any, and a valuation of the assets and liabilities of the society. Apart from this, the form in which the auditor has to submit his audit report reveals the nature of his duties. The auditor of a co-operative society is also required to point out various irregularities, improprieties, and departures from the provisions of the Act, rules framed thereunder, and the bye-laws of the society. The form of the audit report to be submitted by the auditor, as prescribed in various status, contains a number of matters which the auditor has to state or comment upon. For example, the Rules framed under the Maharashtra State Co-operative Societies Act require the auditor to make the usual affirmations pertaining to proper maintenance of books of account, agreement of the financial statements with the books of account, availability of the necessary information and explanations, and true and fair nature of the financial statements. In addition, the information required to be given in the schedule attached to the report of an auditor is as under:

(i) All transactions which appear to be contrary to the provisions of the Act, the rules and bye laws of the society.

(ii) All sums, which ought to have been, but have not been brought into account by the society.

(iii) Any material or property belonging to the society which appears to the auditor to be bad or doubtful of recovery.

(iv) Any material irregularity or impropriety in expenditure or in the realisation of monies due to the society.

(v) Any other matter specified by the Registrar of Societies in this behalf.

In the case of a nil report in any of the matters, above the auditor will have to give a nil report.

Question 2

Mention the duties of Auditor of Co-operative Societies in regard to the following:

(i) Over-due interest.

(ii) Compliance with provisions of Co-operative Act and Rules thereunder.

(iii) Special Report to Registrar of Co-operative Societies. *(9 Marks) (Final May 2002)*

Answer

(i) Overdue interest: Overdue interest should be excluded from interest outstanding and accrued due, while calculating profit. Overdue interest is interest accrued or accruing to the accounts, the amount of which the principal is overdue. In practice an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.

(ii) Compliance with provisions of the Act and Rules: An auditor of a co-operative society is required to point out the infringement with the provisions of the relevant Co-operative Act Rules and bye-laws. The auditor of a co-operative society is also required to point out various irregularities, improprieties, and departure from the provision of the Act, rules framed thereunder and the bye-laws of the society. The financial implications of such infringements should be properly assessed and quantified by the auditor and they should be reported. Some of the State laws contain restrictions on the payment of dividends, which should be noted by the auditor and if dividend is declared in excess of the prescribed percentage, the fact should be reported by the auditor. Auditor should also ensure that various provisions in the Co-operative Societies Act, such as, restriction on borrowings, investment of funds, contribution to education funds, restriction on loans, etc are also complied with.

(iii) Special Report to the Registrar The auditors are required to report on number of matters as prescribed in various states. In addition to the main report, the auditors are also required to submit by way of schedules/audit memorandum information on the working of the company as well. In the course of audit, if the auditor notices serious irregularities, in the working of the company, he would report to the Registrar on such matters. In the following cases, a special report may be necessary:

(a) Personal profiteering by the members of managing committee in the transactions of the Society.

(b) Detection of frauds in relation to expenses, purchases, property and stores of the society.

(c) Specific examples of mis-management and decisions against rules and bye-laws.

(d) Any material impropriety or irregularity in the expenditure or in the realisation of money due to a society.

(e) Any money or property belonging to the society which appears to be bad or doubtful of recovery

(f) In the course of Urban Co-operative Banks, disproportionate advances to vested interest groups to siphon off the funds of the society;

Question 3

Section 292A of the Companies Act, 1956 provides that every Public Company having paid up capital not less than Rs.5 crores shall constitute a Committee of the Board known as "Audit Committee". Briefly discuss the additional requirements as per Section 292A, which are silent in clause 49 of the Listing Agreement. *(8 Marks) (Final Nov 2002)*

Answer

Section 292A was inserted by the Companies (Amendment) Act, 1998 providing for constitution of audit committees by public companies having paid-up capital of not less than Rs. five crores. On the other hand, the Clause 49 was introduced by the SEBI requiring listed entities to comply with audit committee requirements in a phased manner, Clause 49 requires obtaining a certificate from auditors of the entity as regards compliance of conditions of corporate governance specified in the said clause. Though there are differences as to composition of the committee under both these requirements, however, significant additional requirements which are stipulated as per Section 292A of the Companies Act, 1956 and silent in Clause 49 of the Listing Agreement are as under:

(i) The audit committee constituted shall act in accordance with terms of reference to be specified in writing by the Board.

(ii) The recommendations of the audit committee on any matter relating to financial management, including the audit report shall be binding on the Board.

(iii) If the Board does not accept the recommendations of the audit committee, it shall record the reasons thereof and communicate such reasons to the shareholders.

Question 4

Write a short note on-Environmental audit. *(4 Marks) (Final Nov 2002)*

Answer

Environmental Audit: Environmental reporting deals with the disclosure by an entity of environmentally related data, regarding environmental risks, environmental impacts, policies, strategies, targets, costs, liabilities or environmental performance to those who have an interest in such information as an aid to enabling/enriching their relationship with the reporting entity via either the annual report; a stand-alone corporate environmental performance report; or some other medium (e.g. staff newsletter, video, CD ROM, internet site). The reports that are generated after such audits can be either compliance-based reporting or impact-based performance reporting.

Environmental audit deals with verification of information contained in such reports with a view to expressing an opinion thereon. Environmental audit can be performed by external agencies or internal experts (including internal auditors). In practice, environmental audit is not done by a single agency but by various agencies who are experts in the field. Since the subject matter of environmental audit involves multi-disciplinary knowledge and skill, it is preferable to form a team of persons drawn from different disciplines who may assist the chartered accountant in performing the task in an effective manner, generally environmental audits are not required by any statute but are sometimes done at the request of the management to address issues like compliance with environmental laws and regulations, etc.

Question 5

As the Auditor of a NBFC, which is engaged in the acquisition of securities and trading in such securities? List out the special points that may be covered in your audit.

(16 Marks) (Final May 2003)

Answer

Special Points in Audit of NBFCs: As per RBI Act, 1934, NBFC is one whose principal business is that of receiving deposits or that of a financial institution, such as lending, investment in securities, hire purchase finance or equipment leasing. A company which is engaged in the acquisition and trading in such securities to earn profit falls in the category of investment company. First of all it is quite important to ascertain the principal business of company since based on the classification of a company, such a company shall have to comply with various positions relating to limits of public deposits, etc. Second most important point would be ensure that the NBFC has complied with registration requirements and a certification of registration should be seen by the auditor. In case of an investment company, the following special points would also have to be given due attention.

(i) *Physical Verification:* Physical verification of all the shares and securities held by a NBFC. When any security is lodged with an institution or a bank, a certificate from the bank/institution to that effect must be verified. Necessary certificates from depositories, etc. shall also have to be seen.

(ii) *Compliance with Prudential Norms:* NBFC Prudential Norms stipulate that NBFCs should not lend more than 15% of its owned funds to any single borrower and not more than 25% to any single group of borrower. The ceiling on investments in shares by a NBFC in a single entity and the aggregate of investments in a single group of entities have been fixed at 15% and 25% respectively. Moreover, a composite limit of credit to and investments in a single entity/group of entities has been fixed at 25% and 40% respectively of the owned fund of the concerned NBFC.

(iii) *Income from Investments:* Dividend income wherever declared by a company, has been duly received by NBFC and interest wherever due (except in case of NPAs) has been duly accounted for. NBFC prudential norms directions requires dividend income on shares of companies and units of mutual funds to be recognised on cash basis. However, the NBFC has an option to account for dividend income on accrual basis, if the same has been declared by the body corporate in its Annual General meeting and its right receive the payment has been established. Income from bonds/debentures of corporate bodies are to be accounted on accrual basis only if the interest rates on these instruments is predetermined and interest is serviced regularly and not in arrears.

(iv) *Classification of valuation of investments:* Classification of investments as to whether the same are current investments or long term investments. The application of NBFC prudential norms directions and adequate provision for fall in the market value of securities, wherever applicable, have been made there against, as required by the directions. Application of the requirements of AS 13 "Accounting for Investments" (to the extent they are not inconsistent with the directions) have been duly complied with by the NBFC.

(v) A list of subsidiary/group companies from the management and investments made in such companies during the year as also ascertain the basis for arriving at the price paid for the acquisition of such shares.

(vi) In terms of NBFC Directions on Prudential Norms, the NBFCs accepting/holding public deposits have to ensure maintenance of minimum prescribed CRAR at all times. The requirement of CRAR is applicable not only on the reporting dates but also on an on-going basis. The compliance with CRAR and other prudential norms is monitored through the half yearly returns on reporting dates (March 31 and September 30). The return is required to be certified by the Managing Director / Chief Executive Officer of NBFC accepting / holding public deposits stating, *inter alia*, that the company has complied with prudential norms and that the CRAR as disclosed in the return has been correctly determined. The statutory auditors of company also append a report to support the veracity of the certificate given by the company.

(vii) In the case of securities lent/borrowed under the Securities Lending Scheme of SEBI, verity the agreement entered into with the approved intermediary (i.e., the person through whom the lender will deposit and the borrower will borrow the securities for lending/borrowing) with regards to the period of depositing/lending securities, fees for depositing/lending, collateral securities any provision for the return including pre-mature return of the securities deposited/lent.

(viii) Verify that securities of the same type or class are received back by the lender/paid by the borrower at the end of the specified period together with all corporate benefits thereof i.e., dividends, rights, bonus, interest or any other rights or benefit accruing thereon.

Question 6

What is your understanding about the term "Audit of Indirect Taxes"? Explain the steps involved in the Indirect Tax Audit. (8 Marks) (Final Nov 2003)

Answer

Audit of Indirect Taxes: The components of central indirect tax which form a part of the materials cost could be basic customs duty, additional duty of customs, special additional duty, excise duty (Cenvat), special excise duty, additional duties of excise, etc. The various components have a relationship with each other and also with central and local sales tax. The audits of in this area are redirected to the audit under sections 14A and 14AA of the Central Excise Act, 1944. All these audits are conducted by or on behalf of the Government. The steps involved in conducting indirect tax audit are as under:

1. Evaluate the internal control systems in general with specific weight given to the strength of the systems in aiming at the quantification and discharge of the indirect taxes. The auditor should ensure that the accounting system and related internal control in this area are covered in terms of erstwhile AAS 6 (SA 400). Internal control questionnaire may be designed specifically for the area of indirect taxation.
2. Obtains information about the company and the industry. Specific information on amount of imports, percentage of customs, amount of removals, quantum of cenvat-proportion of credit could also be calculated. The walk through of the process from the point of ordering of materials till the receipt of the payment from the customer is advisable.
3. Formulating an audit programme to assist in the actual conduct of the audit. The actual extent of verification would be dependent on the results of the evaluation of the internal controls.
4. Ensure that the audit staff is knowledgeable in the law and the procedures governing the indirect taxes. The examination of the documents, physical verification, reconciliation tracing techniques, comparison of ratios, observation of the activities and discussions of the weaknesses observed should be part of an effective audit.
5. Prepare a report on the indirect tax audit providing specific comments on the statutory information, material matters reported by way of an executive summary and the assertion/qualification that the acceptable accounting policies are in vogue.

Question 7

Write a short note on - Probable format of environmental statement.

(4 Marks) (Final Nov 2003)

Answer

Probable format of "Environmental Statement": The following are the main aspects which may be covered in the probable format of Environmental Statement :

a. Name and address of the owner/occupier of the industry, operation or process.
b. Date of last environmental audit report submitted.
c. Consumption of water and other raw materials during current and previous year.
d. Pollution generated in air and water along with the output and the types of pollutants and the deviation from standards.
e. Generation of hazardous waste in current year and previous year from processes.
f. Quantity of solid waste generated during current year and previous year and from recycling or reutilisation of waste, etc.
g. Disposal practice for different type of waste.
h. Practice in operation for conservation of natural resources.
i. Additional investment proposal for environmental protection including abatement of pollution.

Question 8

What are the key functions of an Energy Auditor? *(8 Marks) (Final May 2004)*

Answer

Key functions of Energy Auditor

Energy auditing is defined as an activity that serves the purposes of assessing energy use pattern of a factory or energy consuming equipment and identifying energy saving opportunities. In that context, energy management involves the basis approaches reducing avoidable losses, improving the effectiveness of energy use, and increasing energy use efficiency. The function of an energy auditor could be compared with that of a financial auditor. The energy auditor is normally expected to give recommendations on efficiency improvements leading to monetary benefits and also advise on energy management issues. Generally, energy auditor for the industry is an external party. The following are some of the key functions of the energy auditor:

(i) Quantification of energy costs and quantities

(ii) To correlate trends of production or activity to energy cost.

(iii) To devise energy database formats to depict to correct picture – By product, department or consumer.

Question 9

(a) State the special features of Co-operative Societies Audit. *(8 Marks)*

(b) Explain the Constitution and functions of Audit Committee under Section 292A of the Companies Act, 1956. *(8 Marks) (Final May 2004)*

Answer:

(a) Special features of Co-operative Societies Audit: The special features of co-operative societies audit, to be borne in mind while conducting the audit are as follows:

1. **Examination of overdue debts:** Overdue debts for a period from six months to five years and more than five years will have to be classified and shall have to be reported by an auditor. Overdue debts have far reaching consequences on the working of a credit society. It affects its working capital position. A further analysis of these overdue debts from the viewpoint of chances of recovery will have to be made, and they will have to be classified as good or bad. The auditor will have to ascertain whether proper provisions for doubtful debts is made and whether the same is satisfactory. The percentage of overdue debts to the working, capital and loans advanced will have to be compared with last year, so as to see whether the trend is increasing or decreasing whether due and proper actions for recovery are taken, the position regarding cases in co-operative courts, District Courts etc. and the results thereof.

2. **Overdue Interest:** Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue.
3. **Certification of Bad Debts:** A peculiar feature regarding the writing off of the bad debts as per Maharashtra State Co-operative Rules, 1961, is very interesting to note. As per Rule No. 49, bad debts can be written off only when they are certified as bad by the auditor. Bad debts and irrecoverable losses before being written off against Bad Debts Funds, Reserve Fund etc. should be certified as bad debts or irrecoverable losses by the auditor where the law so requires. Where no such requirement exists, the managing committee of the society must authorise the write-off.
4. **Valuation of Assets and Liabilities:** Regarding valuation of assets there are no specific provisions or instructions under the Act and Rules and as such due regard shall be had to the general principles of accounting and auditing conventions and standards adopted. The auditor will have to ascertain existence, ownership and valuation of assets. Fixed assets should be valued at cost less adequate provision for depreciation. The incidental expenses incurred in the acquisition and the installation expenses of assets should be properly capitalised. If the difference in the original cost of acquisition and the present market price is of far reaching significance, a note regarding the present market value may be appended; so as to have a proper disclosure in the light of present inflationary conditions. The current assets be valued at cost or market price, whichever is lower. Regarding the liabilities, the auditor should see that all the known liabilities are brought into the account, and the contingent liabilities are stated by way of a note.
5. **Adherence to Co-operative Principles:** The auditor will have to ascertain in general, how far the objects, for which the co-operative organisation is set up, have been achieved in the course of its working. While auditing the expenses, the auditor should see that they are economically incurred and there is no wastage of funds. Middlemen commissions are, as far as possible, avoided and the purchases are made by the committee members directly from the wholesalers. The principles of propriety audit should be followed for the purpose.
6. **Observations of the Provisions of the Act and Rules:** An auditor of a co-operative society is required to point out the infringement with the provisions of Co-operative Societies Act and Rules and bye-laws. The financial implications of such infringements should be properly assessed by the auditor and they should be reported. Some of the State Acts contain restrictions on payment of dividends, which should be noted by the auditor.
7. **Verification of Members' Register and examination of their pass books:** Examination of entries in members, pass books regarding the loan given and its repayments, and confirmation of loan balances in person is very much important in a co-operative organisation to assure that the entries in the books of accounts are free from manipulation.

8. **Special report to the Registrar:** During the course of audit, if the auditor notices that there are some serious irregularities in the working of the society, he may report these special matters to the Registrar, drawing his specific attention such irregularities. The Registrar on receipt of such a special report may take necessary action against the society. In the following cases, for instance a special report may become necessary:

   (i) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.

   (ii) Detection of fraud relating to expenses, purchases, property and stores of the society.

   (iii) Specific examples of mis-management including decisions of management against co-operative principles.

   (iv) In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

9. **Audit classification of society:** After a judgement of an overall performance of the society, the auditor has to award a class to the society. This judgement is to be based on the criteria specified by the Registrar. It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification. The auditor should be very careful, while making a decision about the class of society.

(b) Constitution and Functions of Audit Committee: Section 292A of the Companies Act, 1956 requires that every public company having not less than Rs. 5 crores of paid up capital shall constitute a committee of Board known as Audit Committee. It shall consist of not less than three directors and such number of other Directors as the Board may determine of which two-third shall be directors other than the Managing Director and whole time director. They shall elect one such member amongst them as Chairman. The auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the Audit Committee but shall not have the right to vote.

Every audit committee constituted as above shall act in accordance with the terms of reference specified in writing by a Board. The function of the audit committee as specified in the Companies Act, 1956 are as under:

(i) The audit committee should have discussions with the auditors periodically about the internal control systems, the scope of audit, the audit observations and review the periodical financial statements before submission to the board and also ensure compliance with the internal control systems.

(ii) It shall have the authority to investigate any matter in relation to the items specified in this section or reference to it by the Board and shall have access to the information contained in the records of the company and external professional advice, if necessary.

(iii) Its recommendations on all financial matters including audit report shall be binding on the board.

(iv) The auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the Audit Committee but shall not have the right to vote.

(v) To advise and check the compliance of the organisation for policy and regulation aspects.

While performing the aforesaid key functions, the energy auditor is required to carry out the following activities:

(i) To analyse the historical energy consumption and cost data.

(ii) To conduct preliminary energy audit with the objectives to identify:

  (a) major energy consuming equipment and process;

  (b) obvious inefficiencies and energy wastes; and

  (c) priority areas for further detailed investigation.

(iii) To conduct detailed technical and economic analysis of energy efficiency measures involving large efficiency measures involving large capital investment or long payback periods.

Question 10

*Write a short explanatory note on - Human Resource Accounting. (4 Marks) (*Final May 2004)

Answer

Human Resource Accounting: Human resource is perhaps the most valuable asset in an undertaking. Flamholtz defines human resource as "accounting for people as an organizational resource. It involves measuring the costs incurred by business firm and other organizations to recruit, select, hire, train and develop human assets. It also includes measuring the economic value of people to organisations". This definition gives two methods of valuing human resources, i.e., cost and the economic value. A company may value its human resources on the cost basis, i.e., at the costs incurred by it in procuring and developing these assets. Another method is to work out the replacement values of persons, representing the economic value. According to Flamholtz, an individual possesses value for an organisation because he is capable of rendering future services. Theoretically, therefore, his value to an organisation is equal to the present worth of his expected future services. Thus, an individual's value to an organisation can be defined as the present worth of the set of future services that the person is expected to provide during the period he is anticipated to remain in the organisation. In this connection, putting a monetary value on human resources presents a lot of practical problems particularly from the auditor's view point because of element of subjectivity is inherent in the process of such valuation.

Question 11

Write a short note on - Corporate Governance. *(4 Marks) (*Final Nov 2004)

Answer

Corporate Governance: Corporate governance is the system by which companies are directed and controlled by the management in the best interest of the shareholders and others ensuring greater transparency and better and timely financial reporting. The Board of Directors are responsible for governance of their companies. A number of reports and codes of corporate governance have been published internationally. The Securities and Exchange Board of India (SEBI) had set up a Committee under the Chairmanship of Shri Kumar Manglam Birla to formulate the code of corporate governance. Based on this report, SEBI has by circular in February, 2000 directed stock exchanges to amend the Listing Agreement between them and the entities whose securities are listed on such stock exchanges and include a new Clause 49 in such Listing Agreement. Various clauses deal with composition of board, setting-up of audit committee including scope thereof, remuneration of directors, meetings of Board, contents of management discussions and analysis report, etc. Clause 49 also prescribes that there shall be a separate section on Corporate Governance in the annual reports of company, with a detailed compliance report on Corporate Governance. Non compliance of any mandatory requirement i.e. which is part of the listing agreement with reasons there of and the extent to which the non-mandatory requirements have been adopted, should be specifically highlighted. Further, the entity is required to obtain a certificate from the statutory auditor of the entity as regards compliance of conditions of corporate governance as stipulated in that clause.

Note: SEBI has revised Clause 49 vide its Circular dated October 29, 2004

Question 12

Write a short note on - Special Report by auditor to Registrar of Co-operative Societies.

(4 Marks) (Final May 2005)

Answer

Special Report by Auditor to Registrar of Co-operative Societies: During the course of audit of co-operative societies, if the auditor notices that there are some serious irregularities in the working of the society he may draw specific attention to these matters by a special report. In the following cases, a special report may become necessary:

i) Personal profiteering by members of managing committee in the transaction of the society, which are ultimately detrimental to the interest of the society.

ii) Detection of fraud relating to expenses, purchases, property and stores of the society.

iii) Mis-management and decision against co-operative principles.

iv) In the case of urban co-operative banks, disproportionate advances to vested interest groups and deliberate negligence about the recovery, thereof and cases of reckless advancing without adequate security and credit worthiness of the party.

Question 13

Write a short note on - Preliminary Report under Peer Review. (4 Marks) (Final May 2005)

Answer

Preliminary Report Under Peer Review: In the process of peer review, at the end of the on-site review, the reviewer would send a preliminary report to the practice unit before making any report the Board on the areas in case systems and procedures of the practice unit reviewed have been found to be deficient or where non-compliance with reference to any other matter has been noticed by the reviewer during the course of review. The reviewer has to take care that the report does not contain name of any individual practice unit. However no preliminary report is required if no deficiency or non-compliance is observed. In preparing the report, he should assess the conclusion drawn from the review that indicates deficiency. The report is addressed to the practice unit. The report should also contain a paragraph that discusses the scope of the review. Limitations on the scope of review, if any, with fact thereof should also be communicated in the report. The report should be prepared on the letterhead of the reviewer with date, signature, and membership number and code number allotted to the reviewer.

Question 14

Enumerate some of the areas of concern in an audit of indirect taxes.

(6 Marks)(Final Nov 2005)

Answer

Audit of Indirect Taxes: Same areas of concern in an audit of indirect taxes would be:

(i) Non availment or short / excess availment of control or expert incentives.

(ii) Goods imported duty free or payment at concessional rates without properly complying with conditions.

(iii) Valuation Issues – valuation not in line with customs rules.

(iv) Applicability of the relevant control excise exemptions.

(v) Valuation of goods not removed in normal course using valuation methods not in line with Central Excise Valuation Rules.

(vi) Ignoring Liability under Service Tax on services provided or availed.

(vii) Procedural non-compliance.

(viii) Passing on of duty suffered on imported goods and of locally manufactured goods in excess of actual.

Question 15

Write short notes on the following:

(a) Categories of Non-banking Finance Companies (NBFCs) (4 Marks)(Final Nov 2005)

(b) Powers and duties of an auditor of a Multi-State Co-operative Society

(4 Marks)(Final Nov 2006)

Answer

(a) Categories of Non-banking Finance Companies (NBFCs):

As per Reserve Bank of India Act, 1934, NBFC is one whose principal business is that of receiving deposit or that of a financial institution, such as lending, investment in securities, hire purchase finance or equipment leasing, etc. Categories of such companies are:

(a) Equipment leasing company engaged in equipment leasing or financing of such activity.

(b) Hire purchase company engaged in hire purchase transaction or financing of such transaction.

(c) Investment company engaged in acquisition of securities and trading of securities to earn a profit.

(d) Loan company engaged in providing finance by making loans and advances, or otherwise for any activity other than its own.

(e) Residuary non-banking company which receives deposits under scheme or arrangement, by whatever name called, in one lump sum or in installments by way of contributions or subscriptions or by sale of units or other instruments or in any manner.

(b) Powers and duties of an auditor of a Multi-State Co-operative Society: Under Section 73 of the Multi-State Co-operative Societies Act, 2002 every auditor of a multi – State Co-operative Society shall have a right of access at all times to the books, accounts and vouchers of the Multi-State Co-operative Society whether kept at the head office of the Multi-State Co-operative Society or elsewhere and shall be entitled to require from the officers or other employees of the Multi-State Co-operative Society such information and explanation as the auditor may think necessary for the performance of the duties as an auditor.

As per section 73 (2) the auditor shall make the following inquiries:

(a) Whether loans and advances made by the Multi-State Co-operative Society on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the Multi-State Co-operative or its members;

(b) Whether transactions of the Multi-State Co-operative Society which are represented merely by book entries are not prejudicial to the interest of the Multi-State Co-operative Society;

(c) Whether personal expenses have been charged to revenue account; and

(d) Where it is stated in the books and papers of the Multi-State Co-operative Society that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

Question 16

What are the special points in the audit of a Non-Banking Equipment Leasing Finance Company? (8 Marks)(Final May 2006)

Answer

Special Points in the Audit of Non-Banking Equipment Leasing Finance (NBELF) Company

(i) Ascertain whether the NBFC has an adequate appraisal system for extending equipment leasing finance.

(ii) Verify whether there is an adequate system in place for ensuring installation of assets and their periodic physical verification. In respect of some major transactions, an auditor should arrange for physical verification of the leased assets so as to dispel any doubts that equipment leasing finance was not extended without the corresponding assets being created.

(iii) Ascertain whether the NBFC has an adequate system for monitoring whether the assets have been adequately insured against and regular maintenance of the leased assets is being carried out by the lessee.

(iv) Verify the lease agreement entered into with the lessee in respect of the equipment given on lease.

(v) Verify whether the AS 13 issued by the Institute of Chartered Accountants of India in respect of "Accounting for Investments" has been complied with.

Question 17

Enumerate the main areas to be covered by the auditor in the case of environment audit of an industrial unit. (8 Marks)(Final Nov 2006)

Answer

Main areas to be covered in the case of environment audit of an industrial unit

(i) Layout and design of the factory to provide for the installation pollution control devices with provision for upgradation of pollution control measures to meet regulatory authorities' requirements. Areas of deficiency to be included in the report.

(ii) The use of all resources such as air, water, land, energy, raw material and human resources with minimum waste and interlinking for best results to be looked into and reported.

(iii) It has to be reported whether all pollution control measures in vogue are effective with reference to the type of industry, nature of working and grade of polluting the environment.

(iv) Availability of adequate trained staff and safety amenities with provision for constant upgradation to be verified.

(v) Availability of adequate health care provisions and medical facilities for the workers to be looked into.

(vi) Availability of proper system to eliminate industrial unhygienic State.

(vii) Availability of adequate safeguard against occupational health hazards depending upon the nature of industry to be verified.

(viii) Existence of adequate information system and reporting of compliance of statutory legal provisions to the board at regular intervals to be verified.

(ix) Compliance of regularly mechanism by way of updating the existing environment system with the latest changes in the regulations to be looked into.

(x) It has to be verified as to how social aspects are addressed by the industry as they have an obligation to protect the society from pollution hazards of the industry.

Question 18

Enumerate some of the key functions of the Energy Auditor. *(8 Marks) (Final May 2007)*

Answer

Key functions of the Energy Auditor: Following are some of the key functions of the Energy Auditor:

(i) Quantify energy costs and quantities.

(ii) Correlate trends of production or activity to energy costs.

(iii) Devise energy database formats to ensure they depict the correct picture - by department, consumer, product, etc.

(iv) Advise and check the compliance of the organisation for policy and regulation aspects.

(v) Highlight areas that need attention for detailed investigation.

(vi) Conduct preliminary and detailed energy audits which should include the following:

   (a) Data collection and analysis

   (b) Measurements, mass and energy balances.

   (c) Reviewing energy procurement practices.

   (d) Identification of energy efficiency projects and techno-economic evaluation.

(e) Establishing action plan including energy saving targets, staffing requirements, implementation time requirements, procurement issues, details and cost estimates.

(f) Recommendation on goal setting for energy saving, record keeping, reporting and energy accounting, organization requirements, communications and public relations.

Question 19

Write a short note on - Contents of Audit report of Mutual Fund. (4 Marks) (Final May 2007)

Answer

Audit report of mutual fund: It comprises the following:

(i) The auditor has obtained all information and explanations which, to the best of his knowledge and belief, were necessary for the purpose of the audit.

(ii) The balance sheet and the revenue account give a fair and true view of the scheme, state of affairs and surplus or deficit in the fund for accounting period to which the balance sheet or, as the case may be, the revenue account relates.

(iii) The statement of account has been prepared in accordance with accounting policies and standards as specified in the ninth schedule.

Question 20

Write a short note on - Peer review. (4 Marks) (Final Nov 2007)

Answer

Peer Review: The term "peer" means a person of similar standing. The term "review" means conduct of re-examination or retrospective evaluation of the subject matter. In general, for a professional, the term "peer review" would mean review of work done by a professional, by another professional of similar standing. 'Peer Review' is defined as, a regulatory mechanism for monitoring the performances of professionals for maintaining quality of service expected of them for enhancing the reliance placed by the users of financial statements for economic decision-making.

As per the Statement of Peer Review (ICAI, 2002) "Peer Review" means an examination and review of the systems and procedures to determine whether they have been put in place by the practice unit for ensuring the quality of attestation services as envisaged and implied/mandated by the Technical Standards and whether these were effective or not during the period under review".

The examination and review of a practice unit would be carried out by a "reviewer", i.e., a member, selected from a panel of reviewers maintained by the Board. The term "practice unit" means members in practice, whether practising individually or as a firm of Chartered Accountants.

Question 21

What are the areas to be considered in an Environmental Audit? (8 Marks) (Final Nov 2008)

Answer

Environmental auditor should deal with the following aspects in respect of various industrial units:

(i) **Layout and Design:** To see pollution control devices are installed. Pollution control measures to meet requirement of regulations framed by the Government.

(ii) **Management of Resources:** Air, Water, land, Energy, Raw Material and Human Resources are best used with minimum wastage.

(iii) **Pollution Control System:** An effective system of pollution control exists. All possible measures of control are taken.

(iv) **Emergent Safety Arrangement**: Safety arrangement against sudden possible accidents due to chemical, gas or other explosives. Required safety amenities kept ready and staff awareness created.

(v) **Medical and health Care Facilities:** Proper medical services should be maintained. Regular health check up of workers to be done.

(vi) **Industrial Hygiene** Proper system is maintained to eliminate unhygienic State.

(vii) **Occupational health**: Safe guarding health of workers against occupational health hazards.

(viii) **Information Assimilation and reporting**: Proper information generated and reported by proper distribution of authority, responsibility and delegation and compliance of statutory environmental laws.

(ix) **Environment Impact Assessment:** EIA to start industry, proper system and up gradation whenever necessary.

(x) **Compliance of Regulatory Measure**: Regular training, and knowledge of latest development for persons working on system for acquaintance with latest developments.

NOTE

15

LIABILITIES OF AUDITORS

Question 1

Indicate the precise nature of auditor's liability in the following situations and support your views with authority, if any:

(a) (i) A misstatement had occurred in the prospectus issued by the company. (4 Marks)

(ii) Certain weaknesses in the internal control procedure in the payment of wages in a large construction company were noticed by the statutory auditor who in turn brought the same to the knowledge of the Managing Director of the company. In the subsequent year huge defalcation came to the notice of the management. The origin of the same was traced to the earlier year. The management wants to sue the auditor for negligence and also plans to file a complaint with the Institute. (4 Marks)

(iii) Based upon the legal opinion of a leading advocate, X Ltd. made a provision of Rs.5 crores towards Income Tax liability. The assessing authority has worked out the liability at Rs. 5 crores. It is observed that the opinion of the advocate was inconsistent with legal position with regard to certain revenue items.

(4 Marks)

(b) Y Ltd obtained an actuarial valuation for gratuity liability at the year end. The actuary changed certain basic assumptions for working out the liability at this year end as compared to the ones adopted by him in the preceding year. State auditor's responsibility in this matter. (4 Marks) (Final May 2000)

Answer

(a) (i) Under Section 62 of the Companies Act, 1956, directors of a company and persons connected with the issue of the prospectus as experts (whose reports form part of the prospectus) are liable to pay compensation to aggrieved persons for any misstatement in the prospectus. A professional accountant makes certain reports in the prospectus of a company under the Companies Act, 1956 as an expert. Accordingly, if the misstatement could be attributed to the auditors' report in the prospectus, he would be liable to compensation to the persons who have financially suffered due to their having acted on the basis of the auditor's report in the prospectus. The civil liability under the Companies

Act, 1956 is in addition to the liability under the general law enforceable by suit for recovery of damages on the ground of fraud, etc. The measure of damages under this section is the loss suffered by reason of the untrue statement. Under section 628, an auditor is liable for criminal prosecution, if he, in any return, certificate, balance sheet, prospectus, statement or other document required by or for the purpose of the Act, makes a statement (a) which is false in any material particular knowing it to be false; or (b) which omits any material fact knowing it to be material. If convicted, he can be punished with imprisonment for a term exceeding to two years and also with fine.

(ii) In the given case, certain weaknesses in the internal control procedure in the payment of wages in a large construction company were noticed by the statutory auditor and brought the same to the knowledge of the Managing Director of the company. In the subsequent year, a huge defalcation took place, the ramification of which stretched to the earlier year. The management of the company desires to sue the statutory auditor for negligence. The precise nature of auditor's liability in the case can be ascertained on the basis of the undernoted considerations:

(a) Whether the defalcation emanated from the weaknesses noticed by the statutory auditor, the information regarding which was passed on to the management; and

(b) Whether the statutory auditor properly and adequately extended the audit programme of the previous year having regard to the weaknesses noticed.

Erstwhile AAS 6 (SA 400) on "Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit" clearly mentions that, "as a result of his study and evaluation of internal control and other auditing procedures, the auditor may become aware of weaknesses in internal control. For the benefit of the entity, the auditor should make management aware, on a timely basis, of material weaknesses which have come to his attention. Such weaknesses are usually communicated in writing. It is important to indicate in such communication that it discusses only weaknesses which have come to the attention of the auditor as a result of his audit, and that his examination has not been designed to determine the adequacy of internal control for management purposes". The fact, however, remains that, weaknesses in the design of the internal control system and non-compliance with identified control procedures increase the risk of fraud or error as spelt out in SA 240. It is further stated in SA 240 that, "if circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate". Thus, normally speaking, as long as the auditor took due care in performing the audit work, he cannot be held liable.

The fact that the matter was brought to the notice of the managing director may be a good defence for the auditor as well. According to the judgement of the classic case In *re Kingston Cotton Mills Ltd.,* (1896) it is the duty of the auditor to probe into the depth only when his suspicion is aroused. The statutory auditor, by bringing the weakness to the notice of the managing director had alerted the management which is judicially held to be primarily responsible for protection of the assets of the company and can put forth this as defence against any claim arising subsequent to passing of the information to the management. In a similar case S.*P. Catterson* & *Sons Ltd.* (81 *Acct. L. R.68),* the auditor was acquitted of the charge.

(**Note**: SA 315 issued in December, 2007. The date this Standard (along with SA 330) becomes effective, the existing Standard on Auditing (SA) 400, "Risk Assessments and Internal Control", SA 310, "Knowledge of the Business", and SA 401, "Auditing in a Computer Information Systems Environment", issued in June 2002, April, 2000 and January, 2003, respectively, would stand withdrawn).

(iii) SA 620 on "Using the Work of an Expert" discusses the auditor's responsibility in relation to and the procedures the auditor should consider in, using the work of an expert as audit evidence. During the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert, e.g., legal opinions concerning interpretations of agreements, statutes, regulations, notifications, circulars, etc. Before relying on advocate's opinion, the auditor should have seen that opinion given by the expert is *prima facie* dependable. The question states very clearly that the opinion of the advocate was inconsistent with legal position with regard to certain items. It is, perhaps, quite possible that auditor did not seek reasonable assurance as to the appropriateness of the source data, assumptions and methods used by the expert properly. In fact, SA 620 makes it incumbent upon the part of the auditor to resolve the inconsistency by discussion with the management and the expert in case the expert's' work does not support the related representation in the financial information. The inconsistency in legal opinions could have been detected by the auditor in case he had gone through the same. This seems apparent having regard to wide difference in the liability worked out by the assessing authority. Under the circumstance, the auditor should have rejected the opinion and insisted upon making proper provision. However, since the opinion is manifestly erroneous, the auditor is liable for negligence.

(b) A number of actuarial valuation methods have been developed by the actuarial profession to estimate employer's obligations under defined benefit schemes. While these methods are primarily designed to calculate funding requirements, they are also frequently used to determine retirement benefit costs for accounting purposes. The actuarial method selected for determining accrual of liability and the assumptions made can have a significant effect on the expense to be recorded in each accounting period. Therefore, in carrying out a periodical valuation, an actuary chooses a suitable valuation method and, in consultation with the employer, makes appropriate assumptions about the elements affecting the computations. The assumptions relate to the expected inflow from future contributions and from investments as well as to the expected outgo for benefits. In making an actuarial valuation, the actuary may sometimes effect a change in the actuarial method used or in the assumptions adopted for determining the retirement benefit costs. AS 15 on "Accounting for Retirement Benefits in the Financial Statements of Employers" any alterations in the retirement benefit costs so arising are charged or credited to the statement of profit and loss for the year or, alternatively, spread over a period not more than the expected remaining working lives of the participating employees. Accordingly, a change in the actuarial method used for determining the retirement benefit costs constitutes a change in an accounting policy and thus, the auditor would have to ensure that the same is disclosed and impact on accounts is expressed in quantitative terms.

Question 2

You are the auditor of a company, which raised finance from the capital market on the basis of a prospectus issued a few years back. The main object for raising the finance was specified to be setting up a project on information technology.

The company advanced monies so raised to various parties 'related' to directors. These parties had no standing whatsoever with information technology. In the Balance Sheet, these advances appeared as a current asset under the head "loans unsecured – considered good". There was no mention in the notes to accounts about nature and purpose of such advances. You have given routine audit report without any qualifications. One fine morning the directors and these 'related' parties disappear. The company has just vanished.

Can you be hauled up for professional misconduct? Do you have any liability under any law? (8 Marks) (Final Nov2000)

Answer

Schedule VI to the Companies Act, 1956 was amended in 1996 to show separately "Balance of unutilised monies raised by issue" under the heading of Investments with the aim to ensure that the money is invested properly till it is used for the purpose for which it was raised. Accordingly, a requirement was also included in the Schedule VI as under:

"All unutilised monies out of the issue must be separately disclosed in the Balance Sheet of the company indicating the form in which unutilised funds have been invested."

Schedule VI to the Companies Act, 1956 also requires specific disclosure of loans granted by the company to its directors or parties such as firms or private companies in which director is a member or a director or a member. Thus, the company has failed to comply with the requirements of schedule VI vitiating true and fair view.

Further, the Companies Act, 1956 specifically deals with transactions in which particular directors are interested. Section 297 specifies that Board's consent is required for certain contracts in which particular directors are interested i.e. a director of the company or his relative, a firm in which such a director or relative is a partner, any other partner in such a firm, or a private company of which the director is a member or director, for the sale, purchase or supply of any goods, materials or services. Section 299 requires disclosure of interest by a director as also lays down the procedure to be followed in this regard. Section 301 of the Companies Act, 1956 requires that every company shall keep one or more registers in which shall be entered separately particulars of all contracts or arrangements to which Section 297 or Section 299 applies, including the following particulars to the extent they are applicable in each case, namely:

(a) the date of the contract or arrangement;

(b) the names of the parties thereto;

(c) the principal terms and conditions thereof;

(d) in the case of a contract to which Section 297 applies or in the case of a contract or arrangement to which sub-section (2) of Section 299 applies, the date on which it was placed before the Board;

(e) the names of the directors voting for and against the contract or arrangement and the names of those remaining neutral.

Thus, it is quite natural that the all these particulars should have been recorded in such registers since the company advanced monies to various parties "related" to directors.

Still further, CARO, 2003 issued under Section 227(4A) of the Companies Act, 1956 specifically requires the auditor to comment on the rate of interest and other terms and conditions of loans granted by the company (whether secured or unsecured) to companies, firms or other parties listed in the register maintained under Section 301 of the Act. There may be situations where the company has not properly maintained the register required to be maintained by it under Section 301. In such a case, the auditor should obtain the necessary information regarding the loans taken by the company from companies, firms or other parties in which the directors are interested, from the management of the company. However, while reporting on this clause, the auditor is required to clearly mention the fact of non-maintenance/improper maintenance of the aforesaid register. The auditor's duty is to determine whether, in his opinion, the rate of interest and other terms and conditions of the loans are *prima facie* prejudicial to the interest of the company.

The aforesaid provisions aim to prevent siphoning off of funds as also exercise propriety in case of transactions with related parties and disclosure of the same. It appears that the auditor did not perform his duties properly. In the case of Deputy Secretary of the Government of India, *Ministry of Finance vs. S.N. Dasgupta*, the learned judge made certain observation as regards the duties of the auditor and method they should follow for discharging them satisfactorily and stated that, "verifying not merely the arithmetical accuracy of the statements of account but also their substantial accuracy by confirming that they include all the particulars requiring disclosure by the Articles or the Companies Act and otherwise represents true and fair State of affairs of the company."

Therefore, the auditor has specific obligation to report under the Companies Act, 1956. Thus, he is liable under the Companies Act, 1956 and may be penalised under section 233 since he has performed his duties in a negligent manner. The auditor would also be held liable for professional misconduct under clause 7 of Second Schedule to the Chartered Accountants Act, 1949.

Question 3

Write a short note on - Auditor's liability in case of unlawful acts or defaults by clients.

(4 Marks) (Final Nov 2000)

Answer

Auditor's liability in case of unlawful Acts or defaults by clients: The auditor's basic responsibility is to report whether in his opinion the accounts show a true and fair view and in discharging his responsibility he has to see as to how the particular situations affected his position. The general thinking with regard to unlawful acts or defaults by clients appears to be that the auditor should not 'aid or abet' but he is apparently not under any legal obligation to disclose the offence. A professional accountant would himself be guilty of a criminal offence if he advises his client to commit any criminal offence or helps or encourages in planning or execution of the same or conceals or destroys evidence to obstruct the course of public justice or positively assists his client in evading prosecution. A professional accountant in his capacity as auditor, accountant, or tax representative has access to a variety of information concerning his clients. On some occasions, he may acquire knowledge that his client has been guilty of some unlawful act, default, fraud, or other criminal offence. The duty of the professional accountant in such a case would depend upon the actual circumstances of the situation. Due consideration should be given to the exact nature of services that a professional accountant is rendering to his client, i.e. is he representing the client in income-tax proceedings or is he acting in the capacity of an auditor or an accountant or a consultant.

The Institute of Chartered Accountants of India has considered the role of chartered accountants in relation to taxation frauds by an assessee and has made the following major recommendations:

(i) A professional accountant should keep in mind the provisions of Section 126 of the Evidence Act whereby a barrister, an attorney, a pleader or a Vakil is barred from disclosing any communication made to him in the course of and for the purpose of his employment.

(ii) If the fraud relates to past years when the accountant did not represent the client, the client should be advised to make a disclosure. The accountant should also be careful that the past fraud does not in any way affect the current tax matters.

(iii) In case of fraud relating to accounts examined and reported upon by the professional accountant himself, he should advise the client to make a complete disclosure. In case the client refuses to do so, the accountant should inform him that he is entitled to dissociate himself from the case and that he would make a report to the authorities that the accounts prepared or examined by him are unreliable on account of certain information obtained later. In making such a report, the contents of the information as such should not be communicated unless the client consents in writing.

(iv) In case of suppression in current accounts, the client should be asked to make a full disclosure. If he refuses to do so, the accountant should make a complete reservation in his report and should not associate himself with the return.

However, it can be argued that the auditor has a professional obligation to ensure that the client is fully aware of the seriousness of the offence and to seriously consider full disclosure of the matter.

It has been clearly established in various case laws that the auditor is expected to know the contents of documents and records and ascertain whether the affairs of the client are being conducted in an unlawful manner. It is in the course of the work, he comes across any unlawful acts, it is his duty to bring it to the notice of the client as also to make a disclosure in his report in appropriate cases. In this regard, one has to bear in mind the consequence of the act in relation to the professional code to which an auditor is subjected. Under the code, an auditor cannot disclose confidential information unless permitted by the client or unless required by law. Each case has to be judged on its circumstances. However, in every case he has to assess the implications of the unlawful act or default on the true and fair character of the accounting statements.

The question of liability of an auditor for unlawful acts or defaults by clients should be considered in the light of the broad parameters given above. However, it appears that if an auditor was aware of any unlawful act having been committed by client in respect of accounts audited by him and the unlawfulness was not rectified by proper disclosure or any other appropriate means, the auditor owes a duty to make a suitable report. If he does not, he may be held liable, if the true and fair character of the accounts has been vitiated.

Question 4

Answer the following:

Auditor's liability to third parties in relation to issue of Prospectus.

(8 Marks) (Final Nov 2008)

Answer

Section 62 of the Companies Act, 1956 lays down the civil liability for misstatement in a prospectus issued to invite persons to subscribe for shares in or debentures of a company. The professional accountant will in such a case be liable to pay compensation to every person who subscribes for any shares or debentures on the faith of the prospectus for any loss or damage sustained because of an untrue statement made by him as an expert.

However, professional accountants will not be liable if they can prove that:

(a) the prospectus was issued without his knowledge or consent and that on becoming aware of its issue he forthwith gave reasonable public notice that it was issued without his knowledge or consent; or

(b) he withdrew his consent in writing before delivery of the prospectus for registration; or

(c) after the delivery of prospectus for registration but before allotment of shares, on becoming aware or the untrue statement , he withdrew his consent in writing and gave reasonable public notice of the withdrawal, and of the reasons therefore ; or

(d) he was competent to make the statement and that he had reasonable grounds to believe and did up to the time of allotment of the shares or debentures believe that the statement was true.

16

PROFESSIONAL ETHICS

Question 1

Ajay is a practising Chartered Accountant.Vijay is a practising Advocate representing matters in courts of law. Ajay and Vijay agree to help each other in matters involving their professional expertise. Accordingly Ajay recommends Vijay in all tax litigations in courts of law. Vijay consults Ajay on all matters relating to finance and related matters, which come to him for arguing in various courts of law.

Ajay seeks your advise on how he and Vijay should (i) remunerate each other (ii) 'share' the remuneration. (4 Marks) (Final Nov 2000)

Answer

A chartered accountant in practice shall be deemed to be guilty of professional misconduct if he either directly or indirectly shares commission or brokerage in the fees or profits of his professional business to any other than member of the Institute or accepts any part of the profits of the professional work of a lawyer, broker, etc. who is not a member of the Institute. Thus, as per Clauses 2 and 3 of Part I of the First Schedule to the Chartered Accountants Act, 1949 a member in practice can neither share fees or profits with a person who is not a member of the Institute nor he is permitted to receive and share the fees of other such as lawyers, engineers, etc.

Ajay and Vijay therefore cannot "share" any remuneration. They may however, remunerate each other for "professional" services rendered on any reasonable basis separately which would be on time basis at rates depending on the extent of expertise. It is, however, important that care should be taken by the member not to extend his service beyond the normal sphere of professional practice and any reports or recommendations should clearly delimit the responsibilities assumed and services rendered.

Question 2

Discuss whether the following actions by a Chartered Accountant would amount to misconduct or not:

(i) A Chartered Accountant practising in India enters into partnership with

(a) A Certified Public Accountant in New York.

(b) A Chartered Accountant from the Institute of Chartered Accountants in England and Wales in London, and in each case, the members concerned take the profits earned in their own country.

Will it make any difference, if an Indian Chartered Accountant is practising outside India and becomes a partner with the aforesaid accountants? (4 Marks)

(ii) A Chartered Accountant in service agrees to entrust the work of investment broker to Mr. X on the specific understanding that 20% of commission Mr. X earns would be paid to him. (4 Marks)

(iii) A practising Chartered Accountant uses a visiting card in which he designates himself, besides as Chartered Accountant, as

(a) Tax Consultant

(b) Cost Accountant. (4 Marks)

(iv) A Chartered Accountant in practice takes up the appointment as Managing Director of a Public Limited Company. (4 Marks) (Final Nov 2000)

Answer

(i) (a) **Partnership with a CPA in New York:** Clause (4) of Part I to the First Schedule to the Chartered Accountants Act, 1949 specifies that a chartered accountant in practice shall be deemed to be guilty of professional misconduct in case a member of our Institute enters into partnership with any person other than a chartered accountant in practice.

However, partnership between members of the Institute and members of foreign professional bodies are permissible provided members of such bodies are eligible for the membership of the Institute and provided further that they share in the fees or profits of the business of the partnership both within and without India. Thus, chartered accountant would be guilty of professional misconduct since certified public accountants (CPA) are not eligible to become members of the Institute.

(b) **Partnership with a chartered accountant from ICAEW:** As stated above, it is important that partnership with a member of the foreign professional body is permissible provided *inter alia* such bodies are eligible for the membership of the Institute. Earlier, the Council had passed a resolution permitting chartered accountants from ICAEW to become members of the Institute (Appendix 6) as also fulfilment of certain conditions in respect of persons not permanently residing in India. However, the Council of the Institute at its meeting held in December, 1995 decided to withdraw the resolution w.e.f. December 8, 1995. In view of this, persons qualified from any of the four Institutes in the United Kingdom including England and Wales are not entitled to have their names entered in the Register of Members maintained by the Institute effective from December 8, 1995. Based on this development, partnership between members of the Institute and members of above foreign professional bodies will not be permissible from the above date. Even a chartered accountant from ICAEW who was eligible to become member of the Institute, the profit sharing arrangement stated in the question goes against the provisions of Clause 4. Hence, it would constitute professional misconduct.

Chartered Accountants practising outside India: A member of the Institute of Chartered Accountants of India practising outside India is not governed by the provisions of the Chartered Accountants Act, 1949 since the provisions of the said Act are not applicable outside India. Accordingly, the question of professional misconduct would not arise if an Indian chartered accountant practising outside India becomes a partner with aforesaid accountants and enters into partnership in that country with a member of the Institute of that country. There would be no professional misconduct within the provisions of the Institute of Chartered Accountants Act, 1949 as the applicability of such provisions does not extend to outside India.

(ii) Part II of the First Schedule to the Chartered Accountants Act, 1949 deals with instances of professional misconduct in relation to member of the Institute who is not in practice but is an employee of a firm, company or an individual. Clauses (a) and (b) of Part II correspond to clauses (2) and (3) of Part I of the First Schedule. Clause (b) of Part II of the First Schedule to the Chartered Accountants Act, 1949 prohibits acceptance or agreeing to accept any part of fees, profits or gains from a broker by way of commission or gratification. Thus, chartered accountant in service would be held guilty of professional misconduct since he entrusted the work to Mr X, an investment broker, on the specific understanding that 20% of commission Mr X earns would be payable to him. It is regardless of the fact that he was in whole-time or part-time employment or that he was carrying on practice of accountancy along with his employment.

(iii) (a) **Tax Consultant:** Section 7 of the Chartered Accountants Act, 1949 read with Clause 7 of Part I of the First Schedule to the said Act prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a chartered accountant in documents through which the professional attainments of the member would come to the notice of the public. Under the clause, use of any designation or expression other than chartered accountant for a chartered accountant in practice, on professional documents, visiting cards, etc. amounts to a misconduct unless it be a degree of a university or a title indicating membership of any other professional body recognised by the Central Government or the Council. Thus, it is improper to use designation "Tax Consultant" since neither it is a degree of a University established by law in India or recognised by the Central Government nor it is a recognised professional membership by the Central Government or the Council.

(b) **Cost Accountant:** As stated in the preceding paragraph, this would also constitute misconduct under section 7 of the Act read with Clause (7) of Part I of the First Schedule to the Chartered Accountants Act, 1949. A chartered accountant in practice cannot use any other designation than that of a chartered accountant. Nevertheless, a member in practice may use any other letters or descriptions indicating membership of accountancy bodies which have been approved by the Council. Thus, it is improper for a chartered accountant to state in his documents that he is a "Cost Accountant". However as per Appendix 8 to the Chartered Accountants Act, 1949 the Council has resolved that the members are permitted to use letters indicating membership of the Institute of Cost and Works Accountants but not the designation "Cost Accountant".

(iv) Clause (11) of Part I of the First Schedule to the Chartered Accountants Act, 1949 aims to restrain a member in practice from engaging himself in any business or occupation other than that of a chartered accountant except when permitted by the Council to be so engaged. Regulation 190A of the Chartered Accountants Regulation, 1988 provides that a chartered accountant in practice shall not engage in any business or occupation other than the profession of accountancy, except with the permission granted in accordance with a resolution of the Council. Appendix 10 to Chartered Accountants' Regulations, 1988 provides that a member of the Institute in practice may hold the office of a Managing Director or a whole-time Director of a body corporate within the meaning of the Companies Act, 1956, provided that the member and/or his relatives do not hold substantial interest in such concern, after obtaining the specific and prior approval of the Council. Accordingly, in the absence of specific and prior approval chartered accountant would be held guilty of professional misconduct.

Question 3

Write a short note on - Other Misconduct. *(4 Marks) (Final May 2001)*

Answer

Other Misconduct: A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, 1949 if he is found guilty of any professional or "Other Misconduct". "Other Misconduct" has not been defined in the Act. This provision empowers the Council to inquiry into any misconduct of a member even if it does not arise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards, even in his non-professional work, would expose him to disciplinary action. For example, a member who is found to have forged the will of a relative, would be liable to disciplinary action even though the forgery may not have been done in the course of his professional duty. Other misconduct would also relate to conviction by a competent court for an offence involving moral turpitude punishable with cause transportation on imprisonment to an offence not of a technical nature committed by the member in his professional capacity.

In the absence of a statutory definition of "other misconduct", the question whether a particular act or omission constitutes "other misconduct" has to be decided on the facts and circumstances of each case. In this context, the judgement of the Supreme Court in "*Council of the Institute of Chartered Accountants of India and another vs B. Mukherjee*" reported in Disciplinary Cases Volume III (pages 413 to 422) acquires special significance. After examining the nature, scope and extent of the disciplinary jurisdiction, which can be exercised under the provisions of the Act, the Supreme Court observed as under:

"We therefore, take the view that, if a member of the Institute is found, *prima facie*, guilty of conduct, which, in the opinion of the Council renders him unfit to be a member of the Institute, even though such conduct may not attract any of the provision of the Schedules, it would still be open to the Council to hold an inquiry against the member in respect of such conduct and a finding, against him, in such an inquiry, would justify appropriate action being, taken by the High Court".

Some illustrative examples, where a member may be found guilty of "Other Misconduct", under the aforesaid provisions rendering, himself unfit to be member are:

(i) Where a chartered accountant retains the books of account and documents of the client and fails to return these to the client on request without a reasonable cause.

(ii) Where a chartered accountant makes a material misrepresentation.

(iii) Where a chartered accountant uses the services of his articled or audit clerk for purposes other than professional practice.

(iv) Conviction by a competent court of law for any offence under Section 8 (v) of the Chartered Accountants Act 1949.

(v) Misappropriation by office-bearer of a Regional Council of the Institute, of a large amount and utilisation thereof for his personal use.

(vi) Non-replying within a reasonable time and without a good cause to the letter of the public authorities.

Question 4

As a practising chartered accountant do you approve the following? If not, why?

(a) In a representation to be submitted to a company under section 225(3) of the Companies Act, 1956, the partner of the firm of auditors wants to include the contributions made by the firm in strengthening the control procedures of the company during their association with the company. (4 Marks)

(b) A partner of a firm of chartered accountants during a T.V. interview handed over a bio-data of his firm to the chairperson. Such bio-data detailed the standing of the international firm with which the firm was associated. It also detailed the achievements of the concerned partner and his recognition as an expert in the field of taxation in the country. The chairperson read out the said bio-data during the interview. (4 Marks)

(c) The Chairman of an Audit Committee of a Bluechip Company, who is a chartered accountant asked the firm in which he was previously a partner to quote their fee on a success fee basis so as to ensure that a professional work is assigned to such firm. (4 Marks)

(d) *A firm of chartered accountants were appointed by a company to evaluate the costs of the various products manufactured by it for their information system. One of the partners of the firm of chartered accountants was a non-executive director of the company.*

(4 Marks) (Final Nov 2001)

Answer

(a) Section 225(3) of the Companies Act, 1956 permits a retiring auditor to make a representation in writing (not exceeding a reasonable length) to the company. The proposition of the partner to highlight contributions made by the firm in strengthening the control procedures in the representation is not acceptable because the representation letter should not be prepared in a manner so as to seek publicity. The Code of Ethics issued by the Institute makes it amply clear that the right to make representation does not mean that an auditor has any prescriptive right or a lien on an audit. The wording of his representation should be such that, apart from the opportunity not being abused to secure needless publicity, it does not tantamount directly or indirectly to canvassing or soliciting for his continuance as an auditor. The letter should merely set out in a dignified manner how he has been acting independently and conscientiously through the term of office and may in addition, indicate if he so chooses his willingness to continue as auditor if re-appointed by the shareholders. Thus, such action proposed by a partner could not be approved since, it would lead to his being held guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(b) Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits solicitation of client or professional work either directly or indirectly by circular, advertisement personal communication or interview or by any other means since it shall constitute professional misconduct. The bio-data was handed over to the chairperson during the T.V. interview by the Chartered Accountant which included details about the firm and the achievements of the partner as an expert in the field of taxation. The chairperson simply read out the same in detail about association with the international firm as also the achievements of the partner and his recognition as an expert in the field of taxation. Such an act would definitely lead to the promotion of the firms' name and publicity thereof as well as of the partner and as such the handing over of bio-data cannot be approved. The partner would be held guilty of professional miscount under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(c) Professional services cannot and should not be offered under an agreement which entails that fees shall be payable on a success fee basis. The fees payable, therefore, become contingent in nature. It is obvious that a person who is to receive payment in direct proportion to the benefit received by his client, may be tempted to exaggerate the advantage of his service or may adopt means which are not ethical. It will have the effect of undermining his integrity and impairing his independence. Therefore, the remuneration based on a percentage of the profits or on the happening of a particular contingency such as, the successful outcome of an appeal in revenue proceedings is prohibited. Therefore, the action of the firm to quote fees in such a manner on the advice of the Chairman of the Audit Committee to ensure their appointment could not be accorded approval and the member would be held guilty of professional misconduct under Clause (10) of Part I of the Chartered Accountants Act, 1949.

(**Note:** In the instant case, the Chairman of Audit Committee who also happens to be a chartered accountant would also be guilty of misconduct under the Chartered Accountants Act, 1949.)

(d) The Council of the Institute of Chartered Accountants of India has categorically stated that in cases where a member is a director of a company, the firm in which the said member is a partner, should not express any opinion on its financial statements. Clause 4 of Part I of the Second Schedule desists a chartered accountant to express opinion on financial statements of an enterprise in which he, his firm or a partner in his firm has a substantial interest unless he discloses the interest in his report. Since the firm has been appointed to evaluate the costs of the various products manufactured by it for their information system, it cannot be construed to be a misconduct under Clause (4) Part I of the Second Schedule to Chartered Accountants Act, 1949.

Question 5

Is there any misconduct on the part of a Chartered Accountant in the following circumstances:

(i) Mr. G, a Chartered Accountant in practice as a sole proprietor has an office in Mumbai near Church Gate. Due to increase in professional work, he opens another office in a suburb of Mumbai which is approximately 80 kilometers away from his existing office. For running the new office he employs three retired Income-tax Officers. (4 Marks)

(ii) The offer document of a listed company in which Mr. D, a practising Chartered Accountant is a director mentions the name of Mr. D as a director along with his various professional attainments and spheres of specialisation. (4 Marks) (Final May 2002)

Answer

(i) In terms of section 27 of the CA Act, 1949 if a chartered accountant in practice has more than one office in India, each one of these offices should be in the separate charge of a member of the Institute. There is however an exemption for the above if the second office is located in the same premises, in which the first office is located; or the second office is located in the same city, in which the first office is located; or the second office is located within a distance of 50 kms from the municipal limits of a city, in which the first office is located. Since the second office is situated beyond 50 kms of municipal limits of Mumbai city. Thus he would be liable for committing a professional mis-conduct.

(ii) The Council of the ICAI has in a communication to members stated that if a public company, in which a chartered accountant in practice is a director, issues a prospectus or gives any announcement that gives descriptions about the Chartered Accountant's expertise, specialisation and knowledge in any particular field, it shall constitute a violation of Clauses 6 and 7 of Part I of the First Schedule to the Chartered Accountants Act, 1949. The Council has further stated that in such cases the member concerned has to take necessary steps to ensure that such prospectus or public announcements or public communications do not advertise his professional attainments and also that such prospectus or public announcements or public communications do not directly or indirectly amount to solicitation of clients for professional work by the members. Thus in the instant case, Mr. S would be held to be guilty of professional mis-conduct and liable for disciplinary action.

Question 6

Discuss the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

(a) A Chartered Accountant in practice has been suspended from practice for a period of 6 months and he had surrendered his Certificate of Practice for the said period. During the said period of suspension, though the member did not undertake any audit assignments, he undertook representation assignments for income tax whereby he would appear before the tax authorities in his capacity as a Chartered Accountant. (4 Marks)

(b) Mr. R, a Chartered Accountant in practice has been elected as the treasurer of a Regional Council of the Institute. The Regional Council had organized an international tour through a tour operator during the year for its members. During the audit of the Regional Council, it was found that Mr. R had received a personal benefit of Rs.50,000 from the tour operator. (4 Marks)

(c) Mr. Q a Chartered Accountant in practice as a proprietor died in a road accident. His widow sold the practice of her husband to another Chartered Accountant in practice for Rs.5 lakhs. The price also included right to use the firm name of Mr. Q. (4 Marks)

(d) M/s XYZ, a firm in practice, develops a website "xyz.com". The colour chosen for the website was a very bright green and the web-site was to run on a "push" technology where the names of the partners of the firm and the major clients were to be displayed on the web-site. (4 Marks) (Final Nov 2002)

Answer

(a) Undertaking Tax Representation Work: In the instant case, a chartered accountant not holding certificate of practice cannot take up any other work because it would amount to violation of the relevant provisions of the Chartered Accountants Act, 1949. In case a member is suspended and is not holding Certificate of Practice, he cannot in any other capacity take up any practice separable from his capacity to practises as a member of the Institute. This is because once a member becomes a member of the Institute, he is bound by the provisions of the Chartered Accountants Act, 1949 and its Regulations. If he appears before the income tax authorities, he is only doing so in his capacity as a chartered accountant and a member of the Institute. Having bound himself by the said

Act and its Regulations made thereunder, he cannot then set the Regulations at naught by contending that even though he continues to be a member and has been punished by suspension, he would be entitled to practice in some other capacity. Thus in the instant case, a chartered accountant would not be allowed to represent before the income tax authorities for the period he remains suspended.

(b) **Embezzlement of Funds:** Section 21 of the Chartered Accountants Act, 1949 provides that a member is liable for disciplinary action if he is guilty of any professional or "Other Misconduct." Though the term "Other Misconduct" has not been defined in the said Act, this provision enables the Council to enquire into any misconduct of a member even if it does not arise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards even in his non-professional work, would expose him to disciplinary action. The Council has also laid down that among other things "misappropriation by an office-bearer of a Regional Council of the Institute of a large amount and utilization thereof for his personal use" would amount to "other misconduct". Thus, in the instant case, Mr. R would be liable for disciplinary action.

(c) **Sale of Goodwill:** The Council of the Instituted considered the issue whether the goodwill of a proprietary firm of chartered accountant can be sold/transferred to another eligible member of the Institute, after the death of the proprietor concerned and came to the view that the same is permissible. The Council resolved that the sale/transfer of goodwill in the case of a proprietary firm of chartered accountant to another eligible member of the Institute shall be permitted. It further laid down that in cases where the death of proprietor occurs after 30/8/1998, the goodwill of the deceased member's practice can be sold to another member and permission of the Institute has to be obtained within a year of the death of the proprietor concerned. It is even laid down that in such cases the name of the proprietary firm concerned would not be removed upto a period of one year from the death of the proprietor. Thus, in the instant case, when the widow of Mr. Q sells the practice to another member, it is nothing but goodwill sold to another member. The sale of the practice and the right to use the name is also allowed in terms of the above decision of the Council. Thus the above act of the widow of Mr. Q is permissible.

(d) **Posting of Particulars on Website:** The Council of the Institute had approved posting of particulars on website by Chartered Accountants in practice under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949 subject to the prescribed guidelines. The relevant guidelines in the context of the website hosted by M/s XYZ are:

- ♦ No restriction on the colours used in the website;
- ♦ The websites are run on a "pull" technology and not a "push" technology

- Names of clients and fees charged not to be given.

In view of the above, M/s XYZ would have no restriction on the colours used in the website but failed to satisfy the other two guidelines. Thus, the firm would be liable for professional misconduct since it would amount to soliciting work by advertisement.

Question 7

Write a short note on - Maintenance of branch offices by a Chartered Accountants in practice.

(4 Marks) (Final Nov 2002)

Answer

Maintenance of Branch Offices by a Chartered Accountants in Practice: Section 27 of the Chartered Accountants Act, 1949 requires that if a chartered accountant in practice or a firm of chartered accountants has more than one office in India, i.e., a branch, each of such offices should be in the separate charge of a member of the Institute. Failure on the part of a member or a firm, to have a member in charge of its branch office and a separate member in case of the branches, if more than one, would constitute professional misconduct. However, exemption from the above has been given to members practising in the hilly areas subject to the certain conditions. It is necessary to mention that the Chartered Accountant in charge of the branch of another firm should be associated with him or with the firm either as a partner or as a paid assistant. If he is a paid assistant, he must be in whole time employment with him. The above rule applies in case additional office is situated at a place beyond 50 Kms. from the municipal limits in which the office is situated. The exemption may be granted under proviso to section 27(1) of the Chartered Accountants Act, 1949 to a member or a firm of Chartered Accountants in practice to have a second office without such second office being under the separate charge of a member of the Institute, provided (a) the second office is located in the same premises, in which the first office is located or (b) the second office is located in the same city, in which the first office is located or (c) the second office is located within a distance of 50 km. from the municipal limits of a city, in which the first office is located. A member having two offices of the type referred to above, shall have to declare, which of the two offices is his main office, which would constitute his professional address.

Question 8

(a) Mr. X, a Chartered Accountant accepted his appointment as tax auditor of a firm under Section 44AB, of the Income-tax Act, and commenced the tax audit within two days of his appointment since the client was in a hurry to file Return of Income before the due date. After commencing the audit, Mr. X realised his mistake of accepting this tax audit without sending any communication to the previous tax auditor. In order to rectify his mistake, before signing the tax audit report, he sent a registered post to the previous auditor and obtained the postal acknowledgement. Will Mr. X be held guilty under the CA Act?

(6 Marks)

(b) Mr. J started his practice as Chartered Accountant in 1996. During 1999, he got an offer for the post of Chief Accountant of a Software Development Company, as a fulltime

employee, for a salary of Rs.60,000 per month. On accepting this offer, Mr. J converted his practice into a partnership firm by taking a fresh Chartered Accountant as his partner. Mr. J neither intimated the Institute nor obtained permission from the Institute about his employment. Will Mr. J be held guilty under the CA Act? (6 Marks)

(c) A Chartered Accountant in practice had confirmed in the application made by his articled clerk to the Council for permission to study that the normal working hours of his office were 11 a.m. to 6 p.m. and the hours during which the articled clerk was required to attend college classes were 7 a.m. to 9.30 a.m. On inquiry from Principal of College, it was ascertained that the articled clerk used to attend classes from 10 a.m. to 1.55 p.m. The Chartered Accountant pleaded ignorance about the articled clerk attending the college classes during office hours. Will the Chartered Accountant be held guilty of professional misconduct? (4 Marks) (Final May 2003)

Answer

(a) Communication with the Previous Auditor: As per Clause 8 of Part I of First Schedule to the Chartered Accountants Act, 1949, Mr. X will be held guilty since he has accepted the tax audit, without first communicating with the previous auditor in writing. The object of the incoming auditor communicating in writing with the retiring auditor is to ascertain whether there are any circumstances which warrant him not to accept the appointment, for example, whether the previous auditor has been changed on account of having qualified the report or he had expressed a wish not to continue on account of something inherently wrong with the administration of the business. The retiring auditor may even give out information regarding the condition of the accounts of the client or the reason that impelled him to qualify his report. Under all circumstances, it would be essential for the incoming auditor to carefully consider the facts before deciding whether or not he should accept the audit. As a matter of professional courtesy and professional obligation it is necessary for the new auditor appointed to communicate with such earlier auditor. The Code of Ethics further points out that it would also be a healthy practice if a tax auditor appointed for conducting special audit under the Income-tax Act, 1961 communicates even with the member who has conducted the statutory audit. Considering the above, though Mr. X tried to rectify his mistake, by communicating with the previous tax auditor after accepting the audit but before signing the audit report, the auditor will be held guilty of professional misconduct.

(b) Failure to take Permission Before Accepting Employment: As per Clause 11 of Part I of First Schedule to the Chartered Accountants Act, 1949, Mr. J will be held guilty since he has accepted the full time salaried employment in addition to the practice of Chartered Accountancy without obtaining permission of the Institute. The Chartered Accountants Regulation, 1988 provide that a Chartered Accountant in practice shall not engage in any business or occupation other than the profession of accountancy except with the permission granted in accordance with the provisions contained in Regulation 190A. Part (B) of Appendix 10 to the Chartered Accountants Regulations, 1988 requires member of the Institute in practice to engage in full-time or part-time employment after obtaining the specific and prior approval of the Council. Further, Mr. J will be held guilty of professional misconduct under clause (i) of Part II of Second Schedule to the Chartered Accountants Act, 1949 if contravenes any of the provisions of the Act since he has failed to inform the Institute.

(c) Failure to Observe the Regulations: As per Clause(i) of Part II of Second Schedule to the Chartered Accountants Act, 1949 a member shall be held guilty of professional misconduct if he contravenes any provision of the Act or the regulations made thereunder. The chartered accountant, as per Regulations also, is expected to impart proper practical training. In the instant case, the articled clerk must have not been attending office on a regular basis and the explanation of the Chartered Accountant cannot be accepted particularly in view of the fact that the chartered accountant did not obtain certificate from the Principal to confirm the timings. It is also quite likely that the articled clerk would be availing leave quite often and coming late to the office. Under the circumstances, the Chartered Accountant is guilty of professional misconduct in regard to the discharge of his professional duties.

Question 9

Can a Practicing Chartered Accountant be held guilty of Professional Misconduct under the following circumstances? Give your views with reasons in brief.

(a) Z, a Chartered Accountant wrote several letters to Government Department, pointing out seniority of his firm, sending his life sketch and stating that he had a glorious record of service to the country as well as to the organization of accountancy profession with a view to get the audit work. *(4 Marks)*

(b) W, a Chartered Accountant has sent letters under certificate of posting to the previous auditor informing him his appointment as an auditor before the commencement of audit by him. *(4 Marks)*

(c) P, a Chartered Accountant had accepted appointment as an auditor of QRS Company Limited without ascertaining from the Company whether the requirement of Sections 224 and 225 of the Companies Act had been complied with. However, he realized this defect only after acceptance. *(4 Marks)*

(d) The Cashier of a company committed a fraud and absconded with the proceeds thereof. This happened during the course of the accounting year. The Chief Accountant of the company also did not know about fraud.

In the course of the audit, at the end of the year, the auditor failed to discover the fraud. After the audit was completed, however, the fraud was discovered by the Chief Accountant. Investigation made at that time indicate that the auditor did not exercise proper skill and car and performed his work in a desultory and haphazard manner. With this background, the Directors of the company intend to file disciplinary proceedings against the auditor.

Discuss the position of the auditor with regard to the disciplinary proceedings.

(6 Marks) (Final Nov 2003)

Answer

(a) Solicitation of Professional Work Through Letters: 'Z' a chartered accountant, wrote several letters to Government Department pointing out the seniority of his firm and sending his life sketch and stating that he had rendered glorious service to the country and to the accountancy profession with a view to getting the audit work. Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949 prohibits a member not to solicit professional work by means of advertisement, circular, personal communication or interview or by any other means. Since these letters were clearly in the nature of advertising professional attainments, "Z" was guilty of professional misconduct under clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949.

(b) Communication with the Previous Auditor: Clause 8 of Part I of the First Schedule to the Chartered Accountants Act, 1949 requires communication by the incoming auditor with the previous auditor before accepting a position by him. The Council of the Institute has taken the view that a mere posting of a letter "under certificate of posting" is not sufficient to establish communication with the retiring auditor unless there is some evidence to show that the letter has in fact reached the person communicated with. A Chartered Accountant who relies solely upon a letter posted "under certificate of posting" therefore does so at his own risk. Since the letters were sent by "W" to the previous auditor informing him of his appointment as an auditor before the commencement of audit by him under Certificate of Posting is not sufficient to prove communication with the retiring auditor. In the opinion of the Council, communication by a letter sent "Registered Acknowledgement Due" or by hand against a written acknowledgement would in the normal course provide positive evidence. Hence "W" was guilty of professional misconduct under Clause (8) of Part I of First Schedule to the Chartered Accountants Act, 1949.

(c) Compliance with Sections 224 and 225 of the Companies Act, 1956: Clause 9 of the Part I of the First Schedule to the Chartered Accountants Act, 1949 requires the auditor to ascertain from the company whether the relevant requirements have been complied with or not. However, in the instant case, "P" a chartered accountant, before acceptance of his appointment as an auditor has failed to ascertain whether the provisions of Sections 224 and 225 have been complied with by the company. The fact that "P" has realised this defect only after acceptance would not save him from charge of misconduct. It is necessary for the incoming auditor to verify the relevant records of the company to enable him to ascertain whether the provisions of sections 224 and 225 have been complied with. Therefore, P was guilty of professional misconduct under Clause (9) of Part I of First Schedule to the Chartered Accountants Act, 1949.

(d) Failure to Exercise Reasonable Care and Skill: Apparently, as it appears from the facts of the case that the auditor did not exercise proper skill and care and that he performed his work in a desultory and haphazard manner. In this matter, the test for auditor's liability lies in whether he has applied reasonable care, skill and caution called for in the circumstances of the case and whether he reasonably used all the information that he came across in the course of audit. Cash is a very significant item in any situation and the fact that the cashier had left during the year without notice should have placed the auditor on alert as regards the cash book. In fact, the very fact that the cashier was absconding, i.e., left without any notice constituted sufficient circumstances to excite suspicion of the auditor to probe to the bottom. As per SA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements", it can be concluded that the auditor did not plan and perform the audit with an attitude of professional skepticism. Thus, having regard to this and a fraud has actually taken place during the year, committed by the absconding cashier, it is reasonable to think that *prima facie* there is a case against the auditor for gross negligence. Clause (7) of Part I of Second Schedule to the CA Act, 1949 requires that it is the duty of an auditor to bring to bear in the work he has to perform that skill, care and caution as per the circumstances in an honest and reasonable manner. As it appear from the facts of the case, the auditor has been grossly negligent in performing his duties which constitutes professional misconduct. Thus, such instances require reference to Disciplinary Committee of the Council of the Institute. If a member is found guilty by the Council of any of the acts or omissions stated in the Schedule, its finding with recommendations are to be referred to the High Court for decision.

Question 10

Comment on the following with reference to Chartered Accountants Act, 1949 and schedules thereto:

(a) Mr. Parekh, a Chartered Accountant was invited by the Chamber of Commerce to present a paper in a symposium on the issues facing Indian Leather Industry. During the course of his presentation he shared some of the vital information of his client's business under the impression that it will help the Nation to compete with other countries at international level. *(4 Marks)*

(b) Mr. Shah, a Chartered Accountant certified the financial statements of a company in which his wife is a Director holding substantial interest. *(4 Marks)*

(c) Mr. Joe, a Chartered Accountant during the course of audit of M/s XYZ Ltd. came to know that the company has taken a loan of Rs.10 lakhs from Employees Provident Fund. The said loan was not reflected in the books of account. However, the auditor ignored this information in his report. *(4 Marks)*

(d) Mr. Jain, a Chartered Accountant certified the circulation of "Good Luck" a weekly magazine without examination of financial records and other required documents.

(4 Marks)

(e) A charitable institution entrusted Rs. 10 lakhs with its auditors M/s Ram and Co., a Chartered Accountant firm, to invest in a profitable portfolio. The auditors pending

investment of the money, deposited it in their Savings bank account and no investment was made in the next three months. *(4 Marks) (Final May 2004)*

Answer

(a) Disclosure of Client's Information: Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 deals with the professional misconduct relating to the disclosure of information by a chartered accountant in practice relating to the business of his clients to any person other than his client without the consent of his client or otherwise than as required by any law for the time being in force would amount to breach of confidence. The Code of Ethics further clarifies that such a duty continues even after completion of the assignment. The Chartered Accountant may however, disclose the information in case it is required as a part of performance of his professional duties. In the given case, Mr. Parekh has disclosed vital information of his client's business without the consent of the client under the impression that it will help the nation to compete with other countries at International level. Thus it is a professional misconduct covered by clause(1) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

(b) Disclosure of Substantial Interest: Clause (4) of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that if an auditor expresses his opinion on the financial statements of any business in which his firm or partner in his firm or his relative has substantial interest, he is committing professional misconduct unless he discloses the interest also in his report. Such disclosure is intended to assure the public as regard the faith and confidence that could be reposed in the independent opinion expressed by the auditor. In the given case Mr. Shah, Chartered Accountant, has certified the financial statements of a company in which his wife is a director with substantial interest. Hence this amounts to professional misconduct which attracts clause (4) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

(c) Failure to Disclose Material Facts: As per Clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered Accountant in practice will be held liable for misconduct if he fails to disclose a material fact known to him, which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading. In this case, Mr. Joe has come across an information that a loan of Rs. 10 lakhs has been taken by the company from Employees Provident Fund. This is contravention of Rules and the said loan has not been reflected in the books of accounts. Further, this material fact has also to be disclosed in the financial statements. The very fact that Mr. Joe has failed to disclose this fact in his report, he is attracted by the provisions of professional misconduct under clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

(d) Failure to obtain information: Clause 8 of Part I of Second Schedule to Chartered Accountants Act, 1949 states that if a Chartered Accountant in practice fails to obtain sufficient information to warrant the expression of an opinion or his exceptions are sufficient material to negate the expression of an opinion, the chartered accountant shall be deemed to be guilty of a professional misconduct. Mr. Jain, a Chartered Accountant, certified the circulation figures of Good Luck, a weekly magazine without examination of financial records and other required documents. The chartered accountant should not express his opinion before obtaining the required data and information. As an auditor, Mr Jain ought to have verified the basic records such as print order, printer's bill, number of copies sold and paid for, number of copies returned unsold to ensure the correctness of circulation figures. Thus in the present case Mr. Jain will be held guilty of professional misconduct.

(e) Failure to keep Money in separate Bank Account: If a Chartered Accountant in practice fails to keep moneys of his clients in a separate bank account or fails to use such moneys for purposes for which they are intended then his action would amount to professional misconduct under clause 10 of Part I of Second Schedule to the Chartered Accountants Act, 1949. In the course of his engagement as a professional accountant, a member may be entrusted with moneys belonging to his client. If he should receive such funds, it would be his duty to deposit them in a separate banking account, and to utilise such funds only in accordance with the instructions of the client or for the purposes intended by the client. In the given case by depositing the client's money by M/s Ram and Co., a firm of Chartered Accountants, in their own savings bank account, the auditors have committed a professional misconduct. Hence in the given case, M/s Ram & Co. will be held guilty of professional misconduct.

Question 11

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

(a) A firm of Chartered Accountants was appointed by a company to evaluate the costs of the various products manufactured by it for its information system. One of the partners of the firm was a Non-Executive Director of the company. (4 Marks)

(b) Mr. Qureshi, Chartered Accountant, in practice died in a road accident. His widow proposes to sell the practice of her husband to Mr. Pardeshi, Chartered Accountant, for Rs. 5 lakhs. The price also includes right to use the firm name-Qureshi and Associates. Can widow of Qureshi sell the practice and can Mr. Pardeshi continue to practice in that name as a proprietor? (4 Marks) (Final Nov 2004)

Answer

(a) Evaluation of Cost of Products: Clause 4 of Part I of the Second Schedule to Chartered Accountants Act, 1949 states that expressing an opinion on financial statements of any business or any enterprise in which the auditor, his firm or a partner in his firm has a substantial interest would constitute misconduct, unless he discloses the interest also in his report. Also, the Council of the Institute of Chartered Accountants of India has stated that in cases where a member of the Institute is a director of a company, or the firm in which the said member is a partner, should not express any opinion on its financial statements. As per facts of the case, the firm has been retained to evaluate the cost of products manufactured by it for its information system. It is a part of management consultancy service of the firm and moreover its partner was on the Board. Hence, the firm can perform this assignment and it will not constitute misconduct. However, the firm while accepting the position as auditor in future would have to consider whether it would be possible to act in independent manner and express opinion on financial statements.

(b) **Sale of Goodwill:** With reference to Clause (2) of Part I to the First Schedule to Chartered Accountants' Act, 1949 the Council of the Institute of Chartered Accountants of India had an occasion to consider whether the goodwill of a proprietary concern of chartered accountant can be sold to another member who is otherwise eligible, after the death of the proprietor. It laid down that the sale is permitted subject to certain conditions. It further resolved that the legal heir of the deceased member has to obtain the permission of the Council within a year of the death of the proprietor concerned. Thus in a given case and on the facts, the widow of Mr. Qureshi who has sold the practice for Rs. 5 lakhs is nothing but sale of goodwill. Thus the act of Mrs. Qureshi is permissible.

Question 12

Write a short note on - Other Misconduct. *(4 Marks) (Final Nov 2004)*

Answer

A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, 1949 if he is found guilty of any professional or "Other Misconduct". Other Misconduct has not been defined in the Act. This provision empowers the Council to enquire into any misconduct of a member even if it does not raise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviations from these standards, even in his non-professional work, would expose him to disciplinary action. For example, a member who is found to have forged the will of a relative, would be liable to disciplinary action even though the forgery may not have been done in the course of his professional duty. Other misconduct would also relate to conviction by a competent court for an offence involving moral turpitude punishable with cause transportation on imprisonment to an offence not of a technical nature committed by the member in his professional capacity.

In the absence of a statutory definition of "other misconduct", the question whether a particular act or omission constitutes "other misconduct" has to be decided on the facts and circumstances of each case. In this context, the judgement of the Supreme Court in "Council of the Institute of Chartered Accountants of india and another vs B. Mukherjee" acquires special significance. After examining the nature, scope and extent of the disciplinary jurisdiction, which can be exercised under the provisions of the Act, the Supreme Court observed as under:

"We therefore, take the view that, if a member of the Institute is found, prima facie, guilty of conduct, which, in the opinion of the Council renders him unfit to be a member of the Institute, even though such conduct may not attract any of the provision of the Schedules, it would still be open to the Council to hold an inquiry against the member in respect of such conduct and a finding, against him, in such an inquiry, would justify appropriate action being, taken by the High Court."

Some illustrative examples, where a member may be found guilty of "Other Misconduct", under the aforesaid provisions rendering, himself unfit to be member are;

(i) Where a chartered accountant retains the books of accounts and documents of the client and fails to return these to the client on request without a reasonable cause.

(ii) Where a chartered accountant makes a material misrepresentation.

(iii) Where a chartered accountant uses the services of his articled or audit clerk for purposes other than professional practice.

(iv) Conviction by a competent court of law for any offence under Section 8 (v) of the Chartered Accountants Act, 1949.

(v) Misappropriation by office-bearer of a Regional Council of the Institute, of a large amount and utilisation thereof for his personal use.

(vi) Non-replying within a reasonable time and without a good cause to the letter of the public authorities.

Question 13

Comment on the following with reference to the Chartered Accountants Act, 1949 and Schedules thereto:

(a) L, a chartered accountant did not maintain books of account for his professional earnings on the ground that his income is less than the limits prescribed u/s 44AA of the Income Tax Act, 1961. *(5 Marks)*

(b) M/s. ABC, a firm of Chartered Accountants has taken a loan for acquiring computers, from a company whose Managing Directors' son is an Articled Trainee with A, a partner of M/s ABC. *(4 Marks)*

(c) M/s XYZ, a firm of Chartered Accountants created a website "www.xyzindia.com". The website besides containing details of the firm and bio-data of the partners also contains the photographs of all the partners of the firm. *(5 Marks)*

(d) Z, a Chartered Accountant, certifies a financial forecast of his client which was forwarded to the client's bank based on which the bank sanctioned a loan to the client.

(4 Marks) (Final May 2005)

Answer

(a) Maintenance of Books of Account: Under Clause (ii) of Part II of Second Schedule to the Chartered Accountants Act, 1949, the Institute has specified that if a chartered accountant in practice or the firm of Chartered Accountants of which he is a partner fails to maintain and keep in respect of his/its professional practice, proper books of account including the Cash Book and Ledger, he is deemed to be guilty of professional misconduct. Accordingly, it does not matter whether section 44AA of the Income Tax Act, 1961 applies or not. Hence, Mr. L is guilty of professional misconduct.

(b) **Loan from a Company:** As per Clause (i) of Part II of Second Schedule to the Chartered Accountants Act, 1949, a chartered accountant is deemed to be guilty of professional misconduct if he contravenes any of the provisions of Chartered Accountants Act, 1949 or Regulations made thereunder. Regulation 47 of the Chartered Accountant's Regulations, 1988 prohibits a member from accepting any premiums or loans or any deposit in any form from an articled clerk directly or indirectly. However, M/s ABC has taken loan from a company whose Managing Director happens to be father of articled clerk with Mr. A, a partner of M/s ABC. In this case, the articled trainee has no direct interest in that company. There has been a case wherein a chartered accountant was held guilty of professional misconduct because he took a loan from a firm in which the articled clerk and his father were both interested. But, in this case as per the facts, the articled trainee has no direct interest in the company. However, if relationship, direct or indirect, can be established in view of relationship of articled trainee with MD of the company, Mr. A of M/s ABC would be held liable for professional misconduct. Thus, M/s ABC would be guilty of professional misconduct under this clause if it is proved that the loan was related to the engagement of the articled clerk.

(c) **Hosting Details on Website:** As per detailed guidelines of the ICAI laid down in Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant of the firm can create its own website using any format subject to guidelines. However, the website should be so designed that it does not solicit clients or professional work and should not amount to direct or indirect advertisement. The guidelines of the ICAI to allow a firm to put up the details of the firm, bio-data of partners and display of a passport size photograph. In the case of M/s XYZ, all the guidelines seem to have been complied and there appears to be no violation of the Chartered Accountants Act, 1949 and its Regulations.

(d) **Certification of Financial Forecast:** Under Clause (3) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice is deemed to be guilty of professional misconduct if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast. Accuracy does not refer to arithmetical accuracy. All forecasts are estimates based on certain assumptions duly evaluated on a consideration of various relevant factors and cannot be ascertained with accuracy. The Guidance Note on Accountants Report on Profit Forecasts and/or Financial forecast considered the implications of this clause and made it clear that the chartered accountant can participate in the preparation of profit or financial forecasts and review them. But, first of all, he should clearly indicate in his report the sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts and, secondly, he should not vouch for the accuracy of the forecasts. In the instant case, Mr. Shankar is deemed to be guilty as it appears that he has certified the financial forecast without taking adequate safeguards

Question 14

(a) *A chartered accountant holding certificate of practice and having four articled clerks registered under him accepts appointment as a full-time lecturer in a college. Also he becomes a partner with his brother in a business. Examine his conduct in the light of CA. Act, 1949 and the regulations thereunder.* *(4 Marks)*

(b) *XYZ Co. Ltd. has applied to a bank for loan facilities. The bank on studying the financial statements of the company notices that you are the auditor and requests you to call at the bank for a discussion. In the course of discussions, the bank asks for your opinion regarding the company and also asks for detailed information regarding a few items in the financial statements. The information is available in your working paper file. What should be your response and why?* (*4* Marks)

(c) *A chartered accountant in practice, in spite of repeated requests from the Secretary of the Institute fails to submit form 18. Is he liable for misconduct?* *(4 Marks)*

(d) *A chartered accountant availed a term loan of Rs.10 lakhs from a' nationalised bank for furnishing his office. He issued two cheques for Rs.1 lakh each towards repayment of the loan. The cheques were dishonoured with the remark "Refer to Draw". Is the chartered accountant liable for misconduct?* *(4 Marks) (Final May 2000)*

Answer

(a) Clause (11) of Part I of the First Schedule to the Chartered Accountants Act, 1949 debars a chartered accountant in practice from engaging in any business or occupation other than the profession of chartered accountancy unless permitted by the Council of the Institute so to engage. This clause, in effect, has empowered the Council of the Institute to permit chartered accountants in practice to engage in any other business or occupation considered fit and proper. Accordingly, the Council had formulated Regulations 190A and 191 to the Chartered Accountants Regulations, 1988 to provide a basis for considering applications of chartered accountants seeking permission to engage in other business or occupation. A member can accept full- time lecturership in a college only after obtaining the specific and prior approval of the Council. As also becoming a partner in a business with his brother would require specific permission the chartered accountant is liable for professional misconduct since he failed to obtain specific and prior approval of the Council in each case.

(b) Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 states that a chartered accountant in practice shall be deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of the client or otherwise than as required by law for the time being in force. SA 200 on "Basic Principles Governing an Audit" also reiterates that, "the auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose". In the instant case, the bank has asked the auditor for detailed information regarding few items in the financial statements available in his working papers. Having regard to the position stated earlier, the auditor cannot disclose the information in his possession without specific permission of the client As far as working papers are concerned, SA 230 on "Audit Documentation" states "working papers are the property of the auditor. The auditor may at his discretion, make portions of or extracts from his working papers available to his client". Thus, there is no requirement compelling the auditor to divulge information obtained in the course of audit and included in the working papers to any outside agency except as and when required by any law.

(c) Clause (3) of Part III of the First Schedule requires a member to supply the information called for by the Council or any of its Committees and Clause (i) of Part II of the Second Schedule requires every member of the Institute to act within the framework of the CA Act and the Regulation made thereunder. Under the former clause, it is a misconduct for chartered accountants generally, if they do not supply the information called for by the Council. The Secretary acts for the Council; hence, request from the Secretary amounts to a request from the Council. Besides, it is also a contravention of Regulation of the Chartered Accountants Regulations, 1988. Thus, failure to submit Form 18 (deals with Deed of Assignment of Articles where the Articled Clerk is a minor) constitutes professional misconduct.

(d) A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, 1949 if he is found guilty of any professional or "other misconduct". "Other misconduct" has not been defined in the Act. This provision empowers the Council to enquire into any misconduct of a member even if it does not arise out of its professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standard even in his non-professional work, would expose him to disciplinary action.

In the absence of a statutory definition of 'Other Misconduct', the question whether a particular act, or omission constitutes "other misconduct' has to be decided on the facts and circumstances of each case. In this context in the case of *Council of the Institute of Chartered Accountants of India and others vs. B. Mukherjee,* the Supreme Court observed as under:

If a member of the Institute is found *prima facie,* guilty of conduct, which, in the opinion of the Institute, even though may not attract any of the provision of the schedules, it would still be open to the Council to hold an enquiry against the member in respect of such conduct and a finding against him in such an enquiry, would justify appropriate action being taken by the High Court.

Since April, 1989 the Negotiable Instrument Act, 1881 was amended by the Banking, Public Financial Institutions and Negotiable Instrument Laws (Amendment) Act, 1988 providing that where any cheque drawn by a person for the discharge of any liability is returned by the bank unpaid for the reason of insufficiency of the amount of money standing to the credit of the account on which the cheque was drawn or for the reason that it exceeds the arrangements made by the drawer of the cheque with the Bankers for that account, the drawer of such cheque shall be deemed to have committed an offence. The facts of the case state that the cheque was dishonoured with the remark "Refer to Drawer". In the cases of the dishonouring of cheques with the endorsement "Refer to Drawer", the interpretation is susceptible to more than one and there is no reason, by way of the literal construction, to restrict the interpretation of the same only to 'dishonouring for the reason of insufficiency of funds'. Therefore in case it is proved that the cheques were dishonoured due to insufficiency of funds, the chartered accountant would be held guilty of other misconduct.

Question 15

Comment on the following with reference to the Chartered Accountants Act, 1949 and Schedules thereto:

(a) Mr. S, a Chartered Accountant published a book and gave his personal details as the author. These details also mentioned his professional experience and his present association as partner with M/s RST, a firm. (5 Marks)

(b) Mr C accepted the statutory audit of M/s PSU Ltd., whose net worth is negative for the year 2003-04. The audit was to be conducted for the year 2004-05. The audited accounts for the year 2004-05 showed liability for payment of tax audit fees of Rs.15,000 in favour of Mr E, the previous auditor. (5 Marks)

(c) M/s PQR, a firm of Chartered Accountants with 5 partners has accepted the audit of ABC Pvt. Ltd. for 2004-05 at an audit fee of Rs.2,500. ABC Pvt. Ltd was incorporated in April, 2002, but had commenced operations in January, 2005. (4 Marks)

(d) Mr. P, a Chartered Accountant in practice entered into a partnership with Mr. L, an advocate for sharing of fees for work sent by one to the other. However, due to some disputes, the partnership was dissolved after 1 month without any fees having been received. (4 Marks)(Final Nov 2005)

Answer

(a) Soliciting Professional Work: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 refers to professional misconduct of a member in practice if he solicits client or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means. Therefore, members should not adopt any indirect methods to advertise their professional practice with a view to gain publicity and thereby solicit clients or professional work. Such a restraint must be practised so that members may maintain their independence of judgement and may be able to command the respect of their prospective clients. While elaborating forms of soliciting work, the Council has specified that a member is not permitted to indicate in a book or an article, published by him, the association with any firm of chartered accountants. In this case, Mr. S a chartered accountant, published the book and mentioned his professional experience and his association as a partner with M/s RST, a firm of chartered accountants.

Mr. S being a chartered accountant in practice has committed the professional misconduct by mentioning that at present he is a partner in M/s. RST, a chartered accountants firm.

(b) **Accepting Appointment as an Auditor:** As per notification issued by the Council under Clause (ii) of Part II of the Second Schedule, a member of the Institute of Chartered Accountants of India in practice shall be deemed to be guilty of professional misconduct if he accepts appointment as auditor of an entity in case the undisputed audit fee of another chartered accountant for carrying out the statutory audit under Companies Act, 1956 or various other statutes has not been paid.

As per the proviso, such prohibition shall not apply in case of a sick unit where a sick unit is defined to mean "where the net worth is negative".

In the instant case, though the undisputed fees are unpaid, Mr C would still not be guilty of professional misconduct since the M/s PSU Ltd. is a sick unit having negative net worth for the year 2003-04.

(c) **Accepting audit below certain fees:** Under Clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council has notified that if a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he on behalf of the firm in which he is a partner consisting of 4-8 partners with at least one partner holding a certificate of practice for five years or more accepts or carries out any audit work involving receipt of audit fees of an amount less than Rs.3,000 / Rs.5,000 depending on the population of the city in which it is located. It has been further provided that such a restriction shall not apply to audit of newly formed firms relating to 2 accounting years from the date of commencement of their operations.

In the instant case, though the audit fees of Rs.2,500/- less than that prescribed, but in view of the fact that operations have been commenced by the company M/s ABC Pvt. Ltd. only in January 2005, M/s PQR, chartered accountant, would not be hit by this notification and therefore, would not be guilty of any professional misconduct.

(d) Partnership with non-chartered accountants: As per clause 4 of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant will be guilty of professional misconduct if he enters into partnership with any person other than a chartered accountant in practice or a person resident without India who but for his residence abroad would be entitled to be registered as a member under Claus (v) of Sub-section (1) of Section 4 or whose qualification are recognized by the Central Government or the Council for the purpose of permitting such partnership.

This clause puts a restriction on entering into partnership with a non-chartered accountant for the practice of the profession of chartered accountancy. In the instant case since Mr. P, a chartered accountant, has entered into partnership with Mr. L, an advocate, he would be guilty of professional misconduct irrespective of the fact that no work or fee was shared and the partnership was dissolved after one month since the clause does not permit entering into partnership.

Question 16

Write a short note on - Record of Audit Assignments (as required by ICAI regulations).

(4 Marks)(Final Nov 2005)

Answer

Record of Audit assignments: In exercise of the powers conferred by clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India issued a notification which specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the "specified number of audit assignments of the companies under Section 224 and /or Section 228 of the Companies Act, 1956. As a part of this notification, to meet its requirements, a CA in practice as well as a firm in practice shall maintain a record of the audit assignments accepted as laid out in notification issued by the Council of the ICAI under Part II of Second Schedule to the Chartered Accountants Act, 1949 in respect of ceiling on audits containing following particulars:

(i) Name of Company Audit/ Assignment.

(ii) Regn. No.

(iii) Date of appointment with Registrar of Companies.

(iv) Date of acceptance.

(v) Date on which form 23B filed.

Question 17

Comment on the following with reference to the Chartered Accountants Act, 1949, Code of Ethics and Schedules to the Act:

(a) P, a Chartered Accountant in practice provides management consultancy and other services to his clients. During 2005, looking to the growing needs of his clients to invest in the stock markets, he also advised them on Portfolio Management Services whereby he managed portfolios of some of his clients. (5 Marks)

(b) B, a Chartered Accountant in practice is a partner in 3 firms. While printing his personal letter heads, B gave the names of all the firms in which he is a partner. (4 Marks)

(c) XYZ & Associates, a firm with 5 partners developed a website www.xyzassociates.com. The website also contained a link to "All India Chartered Accountants Association", a voluntary association where X, a partner of the firm is currently the Vice-president.

(4 Marks)

(d) M/s LMN, a firm of Chartered Accountants responded to a tender from a State Government for computerization of land revenue records. For this purpose, the firm also paid Rs.50,000 as earnest deposit as part of the terms of the tender.

(5 Marks)(Final May 2006)

Answer

(a) Advising on Portfolio Management Services: The Council of the Institute of Chartered Accountants of India (ICAI) pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 has passed a resolution permitting "Management Consultancy and other Services" by a Chartered Accountant in practice. A clause of the aforesaid resolution allows Chartered Accountants in practice to act as advisor or consultant to an issue of securities including such matters as drafting of prospectus, filing of documents with SEBI, preparation of publicity budgets, advice regarding selection of brokers, etc. It is, however, specifically stated that CAs in practice are not permitted to undertake the activities of broking, underwriting and portfolio management Services. Thus, a chartered accountant in practice is not permitted to manage portfolios of his clients.

In view of this, P would be guilty of misconduct under the Chartered Accountants Act, 1949.

(b) Advertisement of Professional Attainments: Clause 7 of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public. Even a member is not permitted to specify the date of setting up of practice or establishment of firm. However, there is no prohibition for printing names of all the three firms on the personal letterheads in which a member holding Certificate of Practice is a partner. Thus B is not guilty of any misconduct under the Chartered Accountants Act, 1949.

(c) Developing Website: As per the guidelines laid down under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 in respect of websites by chartered accountants in practice, it is permitted that website may provide a link to the website of ICAI, its Regional Councils, Branches and Government Departments and other professional Bodies like AICPA, ICAEW, CICA. In this case, M/s XYZ Associates provided a link to "All India Chartered Accountants Association" which is not permitted. Hence the firm would be liable for misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(d) Responding to Tenders: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 lays down guidelines for responding to tenders, etc. As per the guidelines if a matter relates to any services other than audit, members can respond to any tender. Further, in respect of a non-exclusive area, members are permitted to pay reasonable amount towards earnest money/security deposits.

In the instance case, since computerization of land revenue records does not fall within exclusive areas for chartered accountants, M/s LMN can respond to tender as well as deposit Rs.50,000 as earnest deposit and shall not have committed any professional misconduct.

Question 18

Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

(a) Mr. Rahul, a locally based Chartered Accountant, accepted an audit assignment at a fee lower than that charged by the previous auditor, who was stationed in another town and had to spend a lot of money on travel for which he did not charge separately. (4 Marks)

(b) The superannuation-cum-pension fund for the employees of a company was under a separate 'trust'. Both the company and the trust were under the same management. The auditor, who was auditing the accounts of the company as well as the trust noted some irregularities in the operation of the trust and commented upon these irregularities in the confidential report given to the trustees, but did not mention about these irregularities in his report on the Annual accounts of the Trust. (5 Marks)

(c) M/s XYZ a firm of Chartered Accountants received Rs. 2 lakhs in January, 2006 on behalf of one of their clients, who has gone abroad and deposited the amount in their Bank account, so that they can return the money to the client in July, 2006, when he is due to return to India. (5 Marks)

(d) Mr. J.J. a practicing Chartered Accountant engages himself as part time finance manager of Quick Return Securities Ltd. He is of the view that as both functions are independent, he need not take permission from the Institute. (4 Marks)(Final Nov 2006)

Answer

(a) **Undercutting of fees**: The case of Mr. Rahul should be analysed in the light of clause 12 of Part I of First Schedule to the Chartered Accountants Act, 1949. Clause 12 of the said Schedule deems a Chartered Accountant in practice to be guilty of professional misconduct "if he accepts a position as auditor previously held by some other chartered Accountant or a restricted state auditor in such conditions as to constitute undercutting''. In considering whether variation in fees charged would constitute undercutting the following factors should be considered:

- the quantum of work;
- incidental and out of pocket expenses and
- other terms of appointment.

Since the previous auditor was stationed in another town and therefore, had to incur higher cost on account of conveyance, and the previously the fee was decided on a composite basis inclusive of travelling expenses of the auditor, it cannot be said that Mr. Rahul has accepted an audit assignment based on under cutting of fees. Accordingly, Clause 12 will not be attracted.

(b) **disclosure of material facts:** A Chartered Accountant in practice is deemed to be guilty of professional misconduct under clause 5 of Part I of the Second Schedule if he "fails to disclose a material fact known to him which is not disclosed in a financial statement but disclosure of which is necessary to make the financial statement not misleading". In this case, the Chartered Accountant was aware of the contraventions and irregularities committed by the trust as these were referred to in the confidential report given by the Chartered Accountant to the trustees of the company. However, he had issued the annual accounts without any qualification. On similar facts it was held by the Supreme Court in Kishorilal Dutta Vs. P. K. Mukherjee that it was the duty of the Chartered Accountant to have disclosed the irregularities and contravention to the beneficiaries of the fund in the statement of accounts signed by him. Accordingly, in the present case also it has to be held that the Chartered Accountant is guilty of professional misconduct if the amount of irregularities is proved material.

(c) **Money of clients to be deposited in separate bank account:** Clause 10 of Part I of Second Schedule states that a Chartered Accountant shall be deemed to be guilty of professional misconduct if "he fails to keep money of his clients in separate banking account or to use such money for the purpose for which they are intended."

XYZ received the money in January, 2006 which is to be paid only in July 2006, hence it should be deposited in a separate bank account. Since in this case XYZ have failed to keep the sum of Rs. 2 lakhs received on behalf of their client in a separate Bank Account and it amounts to professional misconduct under clause 10 of part I of Second Schedule.

Connected case Law : *Mr. R. S. Murugai Vs. (1) S K Gadh & (2) V. K. Bajaj*

(d) Engaging in any business other than the profession of CA: Clause II of Part I of First Schedule of CA Act, 1949 states that a Chartered Accountant is deemed to be guilty of professional misconduct if he engages in any business other than the profession of Chartered Accountant unless permitted by the Council for the same.

In the given case Mr. J. J. a practicing Chartered Accountant is engaging himself as part time Finance Manager without the permission of the Institute which is a misconduct attracted by clause II of Part I of First Schedule.

This is similar to a reported in Re Anil Kumar Case.

Question 19

Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

(a) A chartered accountant in practice created his own website in attractive format and colours and circulated the information contained in the website through E-mail. *(5 Marks)*

(b) A chartered accountant in practice takes up the appointment as managing director of a public limited company. (4 Marks)

(c) S, a practicing chartered accountant gives power of attorney to an employee chartered accountant to sign reports and financial statements, on his behalf. (5 Marks)

(d) A is the auditor of Z Ltd., which has a turnover of Rs. 200 crores. The audit fee for the year is fixed at Rs. 50 lakhs. During the year, the company offers A an assignment of management consultancy within the meaning of Section 2(2)(iv) of the CA Act, 1949 for a remuneration of Rs. 1 crore. A seeks your advice on accepting the assignment.

(4 Marks) (Final May 2007)

Answer

(a) Creation of own website by a chartered accountant/firm of chartered accountants The guidelines approved by the Council of the Institute of Chartered Accountants of India permits creation of own website by a chartered accountant in his or his firm name and no standard format or restriction on colours is there. The chartered accountant or firm, as per the guidelines, should ensure that none of the information contained in the website be circulated on their own or through E-mail or by any other mode except on a specific "Pull" request.

Since in the given case, the chartered accountant circulated the information contained in the website through E-mail, he is guilty of misconduct under clause 6 of Part I of the First Schedule to the Chartered Accountants Act, i.e., a chartered accountant in practice is deemed to be guilty of professional misconduct if he solicits client or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means.

(b) Appointment of a CA in practice as MD of a Public Limited Company: Under clause 11 of Part I of First Schedule to the Chartered Accountants Act, a chartered accountant in practice is deemed to be guilty of professional misconduct, if he engages in any business or occupation other than the profession of chartered accountants, unless permitted by the council so to engage.

However, nothing contained in clause 11 shall disentitle a chartered accountant from being a director of a company, unless he or any of his partners is interested in such company as an auditor.

Regulation 190A, states a member in practice cannot engage himself in any business or occupation other than that of a chartered accountant except when permitted by the council. As per Appendix 10 of CA Regulations, 1988, a CA in practice may hold the office of a Managing Director a Whole-time Director of a body corporate, provided that the member and/or his relatives do not hold substantial interest in such concern, after obtaining the specific and prior approval of the Council.

He should seek prior approval of the council otherwise he would be held guilty of misconduct.

(c) Power of signing reports and financial statements: Under clause 13 of Part I of First Schedule to the Chartered Accountants Act a CA in practice is deemed to be guilty of professional misconduct if he allows a person not being a member of the Institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

This clause read in conjunction with Section 26 of the CA Act,1949 stipulates that no person other than the member of the institute shall sign any document on behalf of a CA in practice or a firm of CA' s in his or its professional capacity.

The term 'Financial Statement' for this purpose would cover an examination of the accounts or financial statements given under a statutory enactment or otherwise. Accordingly S is guilty of professional misconduct under clause 13 of part I of First Schedule and also under clause (1) of Part II of Second Schedule for contravening Section 26.

(d) Appointment as a statutory auditor of a PSUs'/Govt company/companies / listed company/companies and other public company/companies : In exercise of the powers conferred by clause (ii) of part II of the Second Schedule to the CA Act, 1949, the Council of ICAI specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct if he accepts the appointment as a statutory auditor of a PSUs'/Govt company/companies/ listed company/companies and other public company/companies having a turnover of Rs. 50 crores or more in a year and accepts any other work(s) or assignment(s) or service(s) in regard to same undertaking(s) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same undertaking. In view of the above position it would be a misconduct on A's part if he accepts the management consultancy assignment for a fee of Rs. 1 crore.

Question 20

Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

(a) Mr. A, a practicing Chartered Accountant agreed to select and recruit personnel, conduct training programmes for and on behalf of a client. *(5 Marks)*

(b) XY & Co., a firm of Chartered Accountant having 2 partners X & Y, one in charge of Head Office and another in charge of Branch at a distance of 80 Kms, puts up a name-board of the firm in both premises and also in their respective residences. *(5 Marks)*

(c) A practicing Chartered Accountant was appointed to represent a company before the tax authorities. He submitted on behalf of his clients certain information and explanations to the authorities, which were found to be false and misleading. *(4 Marks)*

(d) AB & Co., a firm of Chartered Accountants, included the name of P as a partner while filing an application for empanelment as auditor for Public Sector bank branches. It was subsequently noticed that on the date of application, P was not a partner with AB & Co.

(4 Marks) (Final Nov 2007)

Answer

(a) Under Section 2(2)(iv) of the Chartered Accountants Act, 1949, "A member of the Institute shall be deemed "to be in practice" when individually or in partnership with Chartered Accountants in practice, he, in consideration of remuneration received or to be received renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice. Pursuant to Section 2(2) (iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services".

The definition of the expression "Management Consultancy and other Services" includes Personnel recruitment and selection. Personnel Recruitment and selection includes, development of human resources including designing and conduct of training programmes, work study, job description, job evaluation and evaluations of work loads. So A is not guilty of professional misconduct.

(b) The Council of the Institute has decided that with regard to the use of the name-board, there will be no bar to the putting up of a name-board in the place of residence of a member with the designation of chartered accountant, provided, it is a name-plate or board of an individual member and not of the firm. In the given case partners of X Y & Co., put up a name board of the firm in both offices and also in their respective residences.

Thus the chartered accountants are guilty of misconduct. Distance given in the question is not relevant for deciding.

(c) As per clause 5 of Part I of Second Schedule if a member in practice fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary to make the financial statement not misleading, where he is concerned with that financial statement in a professional capacity, he will be held guilty under clause (5). As per clause 6 of Part I of Second Schedule if he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity, he will be held guilty under clause 6.

In given case, the Chartered Accountant had submitted the statements before the taxation authorities. These statements are based on the data provided by the management of the company. Although the statements prepared were based on incorrect facts and misleading, the Chartered Accountant had only submitted them acting on the instructions of his client as his authorized representative.

Hence the Chartered Accountant would not be held liable for professional misconduct.

(d) Under clause 3 of Part II of second schedule, a Chartered Accountant whether in practice or not is guilty of professional misconduct if he includes in any information, statement, return or form to be submitted to the Institute, Council or any of its committees, Directors (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.

In the instant case A B & Co. included another Chartered Accountant name as partner in his firm, in his application for empanelment as Auditor of branches of Public Sector Banks submitted to the Institute. In fact such a member was not a partner of the said firm on the date of application. He will be held guilty of professional misconduct.

Question 21

Comment on the following with reference to the Chartered Accountants Act, 1949 as amended by the Chartered Accountants (Amendment) Act, 2006 and schedules thereto:

(a) As a Chartered Accountant in practice, you are asked to conduct a review of the "Profit Forecast" prepared by a Company in connection with its application for a Term loans from a bank. *(4 Marks)*

(b) X, a Chartered Accountant availed a loan against his shares held as investments from a nationalized bank. He issued 2 cheques towards repayment of the said loan. Both the cheques were returned back by the bank with the remarks "Refer to Drawer". *(5 Marks)*

(c) BC & Co, a firm of Chartered Accountants, accepted an assignment for audit under State level VAT Act, without any prior communication with the previous auditor. *(4 Marks)*

(d) M, a Chartered Accountant in practice, is the Statutory Auditor of S Ltd. for the year ended 31st March 2008. In January 2008, he was appointed as a Director in H Ltd., which is the holding Company of S Ltd. (5 Marks) (Final May 2008)

Answer

(a) Under Clause 3 of Part I of Second Schedule to The Chartered Accountants Act, 1949, a CA in practice is deemed to be guilty of professional misconduct if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast. "The guidance note on accountants' report on profit/financial forecast" provides that profit forecasts can be prepared or reviewed by a CA provided he discloses in his report the sources of information, the basis of forecasts and major assumptions involved and so long as he does not vouch for the accuracy of the forecast. Hence, the offer can be accepted if the above guidance note is complied with.

(b) A Chartered Accountant is expected to maintain the highest standard of integrity even in his personal affairs and any deviation from these standards, even in his non-professional work would expose him to disciplinary action.

A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, if he is found guilty of any professional or "Other Misconduct".

As per part IV of the First Schedule to the Chartered Accountants Act, A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he in the opinion of the Council, brings disrepute to the profession or the Institute as a result of his action whether or not related to his professional work.

The question whether a particular act or omission constitutes "other misconduct" should be based on fact and circumstances of each case.

Under Negotiable Instruments Act 1881, where any cheque drawn by a person for the discharge of any liability, is returned by the bank unpaid, either for insufficiency of funds or the cheque amount exceeds the arrangements made by the drawer of the cheque, the drawer of such cheque shall be deemed to have committed an offence.

In the given case the cheque was dishonoured with the remark "refer to drawer". However, such dishonour need not necessarily be only due to insufficiency of funds.

If it is proved that the cheques were dishonoured due to insufficiency of funds, the CA would be held guilty of "other misconduct".

(c) As per Clause 8 of Part I of First Schedule to the CA Act, 1949, A chartered accountant in practice is deemed to be guilty of professional misconduct if he accepts a position *as auditor previously* held by another chartered accountant or a certified auditor who has been issued certificate under the Restricted Certificates Rules 1932, without first communicating with him in writing.

In the instant case, BC & Co. accepted VAT – audit under State Level Act, carried out by another firm of chartered accountants in the previous year, without prior communication with the previous auditor.

A communication is mandatory requirement for all types of audit, if the previous auditor is a chartered accountant. Hence, the firm is guilty of professional misconduct.

(d) In terms of clause 11 of Part I of the First Schedule to the CA Act, 1949, a CA in practice cannot engage (unless permitted by the council) in any business or occupation other than the profession of Chartered accountant, but he can be a director of a company wherein he or any of his partners is not interested in such company as auditor.

However, public conscience is expected to be ahead of law and the requirement of independence should be interpreted much more strictly. Members should thus not place themselves in position which would either compromise or jeopardise their independence.

In view of the above, an auditor of a subsidiary cannot be a director of a holding company as it will affect his independence.

Question 22

Comment on the following with reference to the Chartered Accountants Act, 1949 as amended by the Chartered Accountants (amendment) Act, 2006 and Schedules thereto:

(a) Mr. P, Chartered Accountant, proprietor of M/s P & Co. requests the manager of a Bank branch to sanction him a loan for Rs.10 lakhs. He also offers free services to the manager and the staff for filing Income-tax returns for 3 years. (5 Marks)

(b) M/s ABC, a partnership firm carrying on business has complained to the Institute of Chartered Accountants of India (ICAI) that Mr. M, a Chartered Accountant has charged the firm excessive fees for a professional assignment. (5 Marks)

(c) Mr. A, a Chartered Accountant in practice has been appointed editor of a monthly journal which analyses performance of the Stock Market and Mutual Fund Schemes. (4 Marks)

(d) M/s PQR, a firm of Chartered Accountants has been appointed Statutory Auditor of a company on terms whereby fees are payable on a progressive basis. Accordingly, the firm has been paid Rs.50,000 as part of his audit fees, though the audit report is yet to be submitted. (4 Marks) (Final Nov 2008)

Answer

(a) Section 21 of the Chartered Accountant Act deals with provisions relating to "other misconduct"

Supreme Court observed that when a member is prima facie found guilty of any conduct, the Council is empowered to conduct an inquiry in the affairs of conduct and take action against such member even if no specific provisions are made under schedules of the Chartered Accountant Act

It is under clause of "other misconduct" a chartered accountant can be held guilty who has opted coercive methods on a bank for having a loan sanctioned to him.

Thus , P, proprietor of PQR & Co., a chartered accountant , when, offers free services of filing income tax returns of staff & manager of a bank for having sanctioned him a loan of 10 lac rupees is clearly hit by clause of "other misconduct " and is deemed to be guilty of professional misconduct.

(b) The contention of the client of Mr. M that he has charged an excessive fee for a professional assignment does not constitute professional misconduct in the context of the provisions of the Chartered Accountants Act, 1949 and regulation made there under since the matter of fixation of actual fee charged in individual cases depends upon the mutual agreement and understanding between them.

Moreover, scales of fee recommended by the Council of the Institute are recommendatory only.

Therefore Mr. M is not liable for any professional misconduct under the Chartered Accountants Act, 1949

(c) As part clause (II) of part (I) to the first schedule of the Chartered Accountants Act, a chartered accountant in practice is deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council.

Under the above clause, the Council permits (among other things) editorship of professional journals. In the instant case, Mr. A, a Chartered Accountant in practice has been appointed editor of a journal related to Stock Market and Mutual Funds –a publication which cannot be called a professional journal.

Hence Mr. A would be guilty of Professional Misconduct.

(d) As per Section 226, clause (d) of sub section (3), of Companies Act, 1956, states a person indebted to company for an amount exceeding Rs.1000/- or a person who has given any guarantee or provided any security in connection with indebtedness of any third person to the company for an amount exceeding Rs. 1000/- is not qualified for appointment as auditor.

However, where auditor, in terms of his appointment, recovers fees on progressive basis, as and when part work is done without waiting for completion, of the whole job, the research committee of the institute has observed that where, in terms of resolution passed by general meeting, the auditor receives fees on progressive basis, without completion of job, he can not be said to be indebted to the company at any stage.

Accordingly, Mr. Y, the practicing chartered accountant is well within ambit of laws even if he receives Rs. 50,000/- as part of his audit fees, without completion of job. There is also no question of any misconduct under the Chartered Accountant Act and Schedules thereto.

NOTE

17

MANAGEMENT AND OPERATIONAL AUDIT

Question 1

You have been appointed to carry out Management-cum-Operational Audit of a Public Ltd company. State whether the use of quantitative ratios is more effective than the use of financial ratios to gain real insight into the financial statements. (8 Marks) (Final May 2000)

Answer

Significance of Quantitative Ratios

The auditor employs a number of techniques to assess the reliability and validity of financial statements. Ratio analysis is one of such techniques and is a valuable tool for overall assessment. Ratio analysis constitutes a substantive auditing procedure designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. Such an assessment is necessary in organisations having large volume of transactions and in those organisations following mechanised accounting system where it is not possible to check each and every transaction. It has the merit of bringing to focus the abnormal deviations and unexpected variations which the normal routine checking in auditing may fail to reveal. In fact, the underlying problems and distortions are brought to light by this procedure.

Quantitative ratios and reconciliations can be used more effectively than the financial ratios by an auditor. More particularly, the objective of management-cum-operational audit is not only to verify compliance with the control but to suggest measures to improve operational environment and thus increase overall productivity. Financial ratios keep changing with the variations in the price level. In a dynamic economy, price levels seldom remain constant and hence comparison of financial ratios over the years becomes vitiated. Quantitative ratios and reconciliations remain unaffected by changes in price. They reflect certain basic relationships and change only if there is a change in the method of operation, technology, degree of automation, product mix, etc. A comparison of quantitative ratios over the years can reveal pertinent and leading indications of the real state of affairs. An auditor can gain a real insight into financial statements through the underlying quantitative data. The various quantitative ratios which may be calculated are input-output ratio for a manufacturing concern, occupancy ratio for hotels, etc. The overall reconciliation statement in case of stocks, membership fees of club, payroll with number of employees etc. will be very useful and effective. To illustrate, in a manufacturing industry, normally, standard input-output ratios available enable the auditor to compare quantity of input with reference to quantity of output and normal production losses involved therein. In fact, input-output ratios shall be of great significance in measuring efficient use of resources not only within the organisation but also to measure the performance of the entity against industry standards.

The nature of quantitative ratios and reconciliations that an auditor can work out in a particular audit would depend upon the actual circumstances of the case. However, the auditor must keep a few general considerations in mind while using quantitative data. Firstly, he should analyse and use such data mainly as an evidence to support the figures in the statements under audit. The quantitative wastages and losses may be so high or so low that the genuineness of the production, sales or stock figures may become doubtful. Secondly, the auditor should try to correlate vital relationships between physical quantities. In this regard the auditor should establish the cause and effect relationship between activities. In many cases the sequence of activities and their predecessor-successor relationships may be used to work out activity ratios. Thirdly, the auditor may attempt to link a physical quantity with its corresponding monetary figure through an estimated average rate. Thus, the number of members of different categories in a club may be multiplied by the average rate of membership fee for each category of membership. This would be a good check on the figure of the total membership fees. Though working out quantitative ratios involve greater strain on the auditor, it is more rewarding.

Question 2

Write a short note on - Objectives of Operational Audit. (4 Marks) (Final May 2001)

Answer

Objectives of Operational Audit: The need for operational auditing has arisen due to the inadequacy of traditional sources of information for an effective management of the company where the management is at a distance from actual operations due to layers of delegation of responsibility, separating it from actualities in the organisation. Specifically, operational auditing arose from the need of managers responsible for areas beyond their direct observation to be fully, objectively and currently informed about conditions in the units under control. Operational audit is considered as a specialised management information tool to fill the void that conventional information sources fail to fill. Conventional sources of management information are departmental managers, routine performance report, internal audit reports, and periodic special investigation and survey. These conventional sources fail to provide information for the best direction of the department all of whose activities do not come under direct observation of managers.

Operational auditing has filled a very significant vacuum, it has come to provide the management with inexpensive, continuous and objective appraisal of activities, operations and controls to inform the management about achievement of standards and, if otherwise, to inform the management about what has gone wrong and how it has gone wrong. Also, it enlightens the management about possible dangers, constraints and opportunities that may be of immense value to the management.

The scope and quality of operational auditing is predominantly dependent upon management attitudes. An open minded management with broad vision, can appreciate the need of operational auditing and to give it the necessary freedom and sanction to perform what it is capable of performing. Also, the qualities and the sense of perspectives of the operational auditor can mould operational audit in the right shape. Without a combination of these two, operational auditing may not be able to show its distinctive advantages to the organisation. Therefore, there is a possibility of operational auditing having different objectives to fulfil in different organisations. Generally, operational audit objectives include:

(i) Appraisal of controls;

(ii) Evaluation of performance;

(iii) Appraisal of objectives and plans and

(iv) Appraisal of organisational structure.

Thus, the main objective of operational audit is to verify the fulfilment of plans and sound business requirements as also to focus on objectives and their achievement of objectives. A school of thought holds that operational auditing can be stretched to evaluate management objectives and plans. This view stems from the fact that everything in an organisation is the product of basic plans and objectives set by the management. If the management policy favours installation of controls or specifies the extent of controls whether satisfactory or not, controls would have to stay within the policy frame. Therefore, the basic thing that should be evaluated is management policies, plans and objectives. However, it should be noted that there exists considerable opposition to the aforesaid view. The other viewpoint holds that operational auditing by its nature should be confined to operations and related controls. The aim of operational auditing is to appraise operations and controls and their adherence to prescribed or laid-down policies and not to go into the question of appropriateness of plans and objectives are clearly spelt out and properly communicated to the personnel responsible for implementation and whether the personnel have understood the objectives in the sense meant by the management. Also, he can take note of any apparent conflict in the objectives for its effect on operations.

In today's context the concept of modern internal audit suggests that there is no difference in internal and operational audit. The scope of internal audit these days is broad enough to embrace the areas covered by operational audit as well.

Question 3

What are the Management Audit Questionnaires? Give a sample questionnaire for Audit of Inventory. *(10 Marks) (Final Nov 2001)*

Answer

Management Audit Questionnaire: A management audit questionnaire is an important tool for conducting the management audit. It is through these questionnaires that the auditors make an inquiry into important facts by measuring current performance. Such questionnaires aim at a comprehensive and constructive examination of an organisation's management and its assigned tasks. Overall it is concerned with the appraisal of management actions in accomplishing the organisation's objectives. Its primary objective is to highlight weaknesses and deficiencies of the organisation. It includes a review of how well or badly the management functions of planning, organising, directing and controlling are being performed. In addition it evaluates how effective the decision-making process is accomplishing the stated organisation objectives. Within this framework, the questionnaire provides a means for evaluating an organisation's ongoing operations by examining its major functional areas. There are three possible answers to the management audit questions: "Yes", "No" and "N.A.", (not applicable). A "Yes" answer indicates that the specific area, function, or aspect under study is functioning in an acceptable manner; no written explanation is needed in that case. On the other hand, a "no" answer indicates unacceptable performance and should be explained in writing. Questionnaire comments on negative answers not only provide documentation for future reference, but, more important, provide background information for undertaking remedial action. Those questions that are not applicable and should be ignored in the audit are checked in the "N.A." column. The management audit questionnaire does not give answers, but simply asks questions. If all questions are answered with a 'yes', operations are proceeding as desired. On the other hand, if there are one or more 'no' answers, difficulties are being experienced and must be explained in writing. If the question does not apply, the N.A. (not applicable) column is checked. Thus, management audit questionnaire for this part of the audit not only serves as a management tool to analyse the current situation; more importantly, it enables the management auditors to synthesis those elements that are causing organisational difficulties and deficiencies.

Audit of Inventory

A management audit questionnaire for audit of inventory is given below

Long Range Plans

- Is inventory management sufficiently qualified to meet long-range company objectives?
- Are long-range inventory management plans coordinated with: production, purchasing and finance?
- Is inventory properly and efficiently stored to reduce obsolescence, pilferage, etc.
- Is there an adequate system to plan inventory in the long run at optimum levels?
- Are inventory plans and procedures audited periodically?

Short or Medium Range Plans

- Is inventory management sufficiently qualified to meet short or medium range objectives?
- Are inventories under control as to type and amount?
- Are short-range inventory management plans an integral part of production and purchasing?
- Is there an adequate inventory system to plan current inventory at optimum levels detect theft and compare physical to perpetual inventories?
- Are lead times figured into inventory levels for purchasing and manufacturing?
- Are reorder levels set?
- Do the plans include 'make' or 'buy' decisions to lower costs?

Organisation Structure

- Is the inventory department under directions of a suitable person?
- Are the inventories and their in-plant movements organised and reported by their basic types, i.e., raw materials, work in progress and finished goods?
- Is there an effective system of physical inventory to disclose any irregularities or losses?
- Is the ABC analysis followed for the inventory control?

Communication

- Is there an information system utilised that employs efficient management, methods and techniques to control inventories and to prepare periodic inventory reports that are of great value to management?
- Is there an effective communication system designed to assist in, keeping the inventory turnover rate high?
- Is there good managerial control over movement of work-in-process materials so that this inventory is kept at a minimum?

Control

- Are inventory management control reports, methods and techniques integrated with production and purchasing?
- Are inventories properly stored to provide a minimum of:
  a. obsolescence?
  b. deterioration?
  c. pilferage?

- Is inventory control integrated with:
  - a. economic order quantities?
  - b. re-order points?
- Have steps been taken to balance the cost generated by too small an inventory against the cost of carrying excessive inventories to determine an optimum inventory turnover?
- Are inventory items physically counted to make sure that perpetual inventory records are accurate?
- Is inventory controlled through the use of the ABC concept (A = high-value items, B = medium-value items, C = low-value items)?
- Is there an effective management control system for receiving materials that are not on a purchase order, i.e., products returned by customers?

Note: Students may note that columns relating to 'Yes', 'No' and 'N.A.' have been omitted.

Question 4

"Operational auditing is not different from internal auditing." Discuss.

(8 Marks) (Final May 2002)

Answer

Internal auditing is an activity carried out by the internal staff of the organisation to meet the management requirements of information. The definition of internal auditing as given by the Institute of Internal Auditors of New York, in fact, is so wide in its scope that it covers both operational and management auditing. According to the Institute of Internal Auditors, "the overall objective of internal auditing is to assist all members of management in the objective discharge of their responsibilities, by furnishing them with objective analysis, appraisals, recommendations and pertinent comments concerning the activities reviewed. The internal auditor, therefore, should be concerned with any phase of business activity wherein he can be of service to organisation". According to the definition, the overall objective of internal auditing is to assist all members of management in the objective discharge of their responsibilities, by furnishing them with objective analysis, appraisals, recommendations and relevant comments concerning the activities reviewed. The internal auditor, therefore, should be concerned with any phase of business activity wherein he can be of service to the organisation. Naturally, when an auditor is concerned with the appraisal of operations, he would be performing the role of an operational auditor. Another important point that this definition throws up is that operational auditing is essentially a function of internal auditing staff. Traditionally, the internal auditing was concerned with the financial transactions only. It was during early 1940's, the concept of operational auditing came into existence. According to Cadmus "operational auditing is not different from internal auditing, it is merely an extension of internal auditing into operational areas. It is characterised in both financial and operational areas – by the auditor's approach and state of mind". The main objective of operational auditing is to verify the fulfilment of plans and sound business requirements as also to focus on objectives and their achievement as against the performance yardsticks evident from in the management objectives, goals and plans, budgets records of past performance, policies and procedures. Industry standards can be obtained from the statistics provided by industry, associations and government sources. It should be appreciated that the standards may be relative depending upon the situation and circumstances; the operational auditor may have to apply them with suitable adjustments. It might appear from the above that an internal auditor is not concerned with operational aspects and operational auditor is, not concerned with financial aspects which is not so . Because traditionally, internal auditors had been engaged in a sort of protective function, deriving their authority from the management. They examined internal controls in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are not there; they checked the accounting books and records to see, whether the internal checks are properly working and the resulting accounting data are reliable. They also looked into the aspect of safety of the assets and properties of the company. Some element of operational auditing could be found even in these traditional functions of internal auditors, specially in the context of fraud, wastage and loss. Internal auditors emboldened by their ability to appraise financial and accounting control gradually started extending their field to cover non-accounting control as well. On the other hand, it should not be assumed, that, since an operational auditor is concerned with the audit of operations and review of operating conditions, he is not concerned with the financial aspects of transaction and controls. A point has already been made that the special expertise acquired by the operational auditor, that enables him to view the controls and operations from the management point of view, can be carried back to his review of the financial areas. In the matter of cash transactions, the operational auditor will look into such aspects as the quantum of cash in hand (by relating it to the requirement of cash to be held) carried generally or the use of cash not immediately required. Also he will review the operational control on cash to determine whether maximum possible protection has been given to cash. Similarly, in the audit of stocks, he would have management policy. In pure administrative areas on stock, he will see whether adequate security and insurance arrangements exist for protection of stocks.

Thus, over a period of time, the scope of internal auditing was widened to cover not only accounting and financial operations but other operations such as marketing, personnel, production, etc. As per the modern definition of internal auditing, there is no difference between the two. However, still some auditors believe that there might exist difference between the two on account of perception as far as scope of the two is concerned which in fact is not true as evident from the foregoing analysis.

Question 5

Explain in brief the behavioural aspects encountered in the management audit and state the ways to solve them. *(8 Marks) (Final May 2004)*

Answer

Behavioural aspects encountered in Management Audit

Financial auditors deal mainly with figures. Management auditors deal mainly with people. There are many causes for behavioural problems arising in the review function of management audit. Particularly, when management auditors performs comprehensive audit of operations, they cannot be as well informed about such operations as a financial auditor in a financial department. Operating processes may be unfamiliar and complex. The operating people may be speaking a language and using terms that are foreign to the auditor's experience. The nature and causes of behavioural problems that the management auditor is likely to face in the discharge of the review function that is expected of him and possible solutions to overcome these problems are discussed below:

(1) **Staff / Line conflict**: Management auditors are staff people while the members of other departments are line people. Management auditors tend to discount the difficulties the line staff may face, if called on to act on the ideas of management auditors. Management auditors are specialists in their field and they may think their approach and solutions are the only answers.

(2) **Control**: The management auditor is expected to evaluate the effectiveness of controls, there is an instinctive reaction from the auditee that the report of the auditor may affect them. There is a fear that the action taken based on the management audit report will affect the line people. It breeds antagonism. The causes are as under:

   (i) Fear of criticism stemming from adverse audit findings.

   (ii) Fear of change in day to day working habits because of changes resulting from audit recommendations.

   (iii) Punitive action by superior prompted by reported deficiencies.

   (iv) Insensitive audit practices.

   (v) Hostile audit style.

Solution to behavioural problems: The following steps may be taken to overcome the aforesaid problems:

(i) To demonstrate that audit is part of an overall programme of review for protective and constructive benefit.

(ii) To demonstrate the objective of review is to provide maximum service in all feasible managerial dimensions.

(iii) To demonstrate the review will be with minimum interference with regular operation.

(iv) The responsible officers will be involved in the process of review of the findings and recommendations before the audit report is formally released.

It is essential to create an atmosphere of trust and friendliness so that audit reports will be understood in their proper perspective.

Finally, it needs hardly any emphasis that there should be right management culture, enlightened auditees and auditors of the right calibre. May be to expect a combination at all times of all the three is asking for the impossible. But, a concerted effort by the management, auditors and auditees to achieve a more acceptable climate would go a long way to achieve the goal.

Question 6

You have been appointed Management Auditor of a large manufacturing company suffering from working capital crunch. Enlist and discuss the related areas which you would probe into to overcome the company's problem. (8 Marks) (Final Nov 2004)

Answer

Adequate working capital is required for liquidity and smooth operations of the company. To ensure an adequate flow of working capital to the manufacturing company, the following action plan may be considered:

(i) ***Working Capital Estimation***: The company should start by preparing a statement of the projected working capital requirements. This should be based on the functional budgets in sales, production, expenses, capital expenditure and the master budget consisting of projected profit and loss and the balance sheet.

(ii) ***Cash Flow Statement / Cash Budget***: Month-wise cash budgets showing inflows and outflows of cash heading-wise should be prepared to analyse the major inflows and outflows affecting the entity. At this stage any wasteful outflow can be traced and eliminated. Bank reconciliation should be undertaken periodically so that outstandings can be traced and acted upon. This is also necessary to reduce the float time.

(iii) ***Inventory / Stock Management***: Raw materials and inventories should be classified properly to determine the level of stock of materials. The method of costing also needs to be looked at minutely. There is a need to establish linkage with the production pattern and work backwards accounting for time factor in receipt of material. This needs to be worked out carefully since at no cost, production schedule should be hampered. The caution also need to be exercised that there is no unused/obsolete inventory. The system of inventory management needs to be looked at so as to check the avoidable wastes/scraps generated during storage and handling. Just in time philosophy will enable the company to reduce processing time, stocks and related costs. The adoption of such a mechanism would bring down the cost to a considerable extent.

(iv) ***Credit Management***: The company should lay down a proper policy for evaluating customers, determining the credit period and offering discounts for early payment. An age-wise analysis of debtors should also be prepared so as to avoid credit to defaulters. The sale department need to be geared up so that realisation can be made in time. A careful analysis should be done of various customers according to pattern of sales so as to exercise control on their respective debit balances. The company should through its purchase department endeavour to avail the maximum credit period from its creditors. This would enhance the working capital of the company.

(v) ***Funds Flow Analysis***: The company should prepare a funds flow analysis, distinguishing between long-term and short-term sources and applications.

(vi) ***Investment Management:*** The idle funds of the company, if any, should be invested in short-term securities to augment the income.

(vii) ***WIP Analysis***: Minimum WIP should be monitored and for the purpose it is necessary to ensure that no bottlenecks develop at any stage during the production process.

Question 7

Briefly explain the objectives of Operational Audit. *(5 Marks)(Final Nov 2005)*

Answer

Objectives of Operational Audit

The scope and quality of operational auditing is predominantly dependent upon management attitudes. An open minded management with broad vision, can appreciate the need of operational auditing and to give it the necessary freedom and sanction to perform what it is capable of performing. Also, the qualities and the sense of perspectives of the operational auditor can mould operational audit in the right shape. Therefore, there is a possibility of operational auditing having different objectives to fulfil in different considerations. Generally, operational audit objectives include:

(i) **Appraisal of controls:** The most significant gain an organisation can derive from operational auditing is probably in the area of appraisal of controls. Internal controls, because of their unobtrusive omnipresence in the organisation, provide the essential hinges to ensure proper performance in each functional or organisational area for accomplishing the desired organisational objective.

(ii) **Evaluation of performance:** In performance appraisal, the operational auditor is basically concerned not so much with how well technically the operations are going on, but with accumulating information and evidence to measure the effectiveness, efficiency and economy with which the operations are being carried on. The principal basis of performance evaluation can be productivity, personnel, workload, cost and quality. In the area of productivity, the operational auditor can undertake such tests as input-output ratios for materials and labour in quantitative terms.

(iii) **Appraisal of objectives and plans:** Everything in an organisation is the product of basic plans and objectives set by the management. If the management policy favours installation of controls or specifies the extent of controls whether satisfactory or not, controls would have to stay within the policy frame. Therefore, the basic thing that should be evaluated is management policies, plans and objectives. Operational auditor may look into the aspects like whether objectives are clearly spelt out and properly communicated to the personnel responsible for implementation and whether the personnel have understood the objectives in the sense meant by the management. Also, he can take note of any apparent conflict in the objectives for its effect on operations.

(iv) **Appraisal of organisational structure:** Organisational structure provides the line of relationships and delegation of authority and tasks. This is an important element of the internal control design. Therefore, this is also another important area for appraisal by the operational auditor. In evaluating organisational structure, the aspects that may be considered by the operational auditor whether the organisational structure in conformity with management objectives and is drawn up on the basis of matching of responsibility and authority.

Question 8

Write a short note on - Broad objectives of operational audit. *(4 Marks)(Final Nov 2006)*

Answer

Broad objectives of operational audit

(i) Appraisal of controls: Operations and the results in which management is interested are largely a matter of control. If controls are effective in design and are faithfully adhered to the result that can be attained will be subject to the other limiting constraints in the organization.

(ii) Evaluation of performance: In the task of performance evaluation, an operational auditor is heavily dependent upon availability of acceptable standards. The operational auditor cannot be expected to possess technical background in so many diverse technical fields obtaining even in one enterprise. Even when examining or appraising performance or reports of performance, the operational auditor's mind is invariably fixed on control aspects.

(iii) Appraisal of objectives and plans: In performance appraisal, the operational auditor is basically concerned not so much with how well technically the operations are going on, but with accumulating information and evidence to measure the effectiveness, efficiency and economy with which the operations are being carried on.

(iv) Appraisal of organisational structure: Organisational structure provides the line of relationships and delegation of authority and tasks. This is an important element of the internal control design. In evaluating organisational structure, the operational auditor should consider whether the structure is in conformity with the management objectives and it is drawn up on the basis of matching of responsibility and authority. He should also analyse whether line of responsibility has been fixed, whether delegation of responsibility or authority is clear and there is no overlapping area.

Question 9

K Ltd., requires you to organize a Management audit program. Briefly state a plan of action.

(8 Marks) (Final May 2007)

Answer

Organizing a Management Audit for K Ltd.: The key requirement for a successful Management audit program would be the approval and support of the top management to initiate. Accordingly the following shall be the matters that should be considered while organizing the Management Audit of K. Ltd.

(i) **Devising a statement of policy** : In consultation with the top Management, a policy statement on management should be issued. The policy should ideally cover the scope, objective, the authority of the management audit function. In short the policy should be drafted to become a charter of management audit .

(ii) **Location of audit function within the organization**: The hierarchical status of the management auditor and his team should be clearly defined.

(iii) **Allocation of personnel** : The management audit team should comprise of personnel who have adequate experience on all the facets of the organization, Ideally it should comprise of technical audit team.

(iv) **Staff Training** : In order to maintain qualitative standards, adequate and continuous training should be offered to the management audit team.

(v) **Time and other aspects** : While planning management audit adequate consideration should be given to time & cost involved in conducting the audit.

(vi) **Frequency of audit** : depending on the pace of change that happens in that industry, the frequency of the management audit should be determined. This can be fixed in consultation with the top management.

Question 10

What are the major differences between Financial and Operational Auditing?

(8 Marks) (Final May 2008)

Answer

The major differences between financial and operational auditing can be described as follows:

(i) Purpose: The financial auditing is basically concerned with the opinion that whether the historical information recorded is correct or not, whereas the operational auditing emphasizes on effectiveness and efficiency of operations for future performance.

(ii) Area: Financial audits are restricted to the matters directly affecting the appropriateness of the presented financial statements whereas the operational audit covers all the activities that are related to efficiency and effectiveness of operations directed towards accomplishment of objectives of organisation.

(iii) Reporting: The financial audit report is sent to all stock holders, bankers and other persons having interest in the organisation. However, the operational audit report is primarily for the management.

(iv) End task :The financial audit has reporting the findings to the persons getting the repost as its end objectives, however, the operational audit is not limited to the reporting only, but includes suggestions for improvements also.

The main objective of operational auditing is to verify the fulfillment of plans, and sound business requirements. Operational auditing is considered as specialized management information tool. Operational auditing is essentially a function of internal auditing staff. Operational auditing is a systematic process of evaluating an organisation's effectiveness, efficiency and economy of operations under management control and reporting to appropriate persons, the result of the evaluation along with recommendations for improvements. Operational audit concentrates on effectiveness, efficiency and economy of operations and therefore it is future oriented. It does not end with the reporting of the findings but also recommends the steps for improvements in future. Operational auditing is not different from internal auditing, it is merely an extension of internal auditing into operational areas.

While in financial auditing, the concentration is more in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are minimized or removed. In financial auditing, an auditor is called upon to review the financial statements of an enterprise to ascertain whether they reflect true and fair view of its state of affairs and of its working results. He may analyse the operations of an enterprise to appraise their cost effectiveness and also he may seek evidence to review the managerial performances.

Question 11

Write a short note on - Integral Foreign Operations. *(4 Marks) (Final May 2008)*

Answer

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

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

NOTE

APPENDIX

Question 1

Write short notes on the following:

(a) *Suspension of capitalisation of borrowing costs* *(4 Marks) (Final Nov 2001)*

(b) *Monetary items and its treatment on balance sheet date* *(4Marks) (Final Nov 2001)*

(c) *Changes in Accounting Policies* *(4 Marks) (Final Nov 2002)*

(d) *Key management personnel* *(4 Marks) (Final Nov 2002)*

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

(4 Marks) (Final Nov 2003)

(f) *Effect of uncertainties on revenue recognition* *(4 Marks)(Final Nov 2006)*

Answer

(a) Suspension of Capitalisation of Borrowing Costs: Accounting Standard 16 on 'Borrowing Costs', prescribes the accounting treatment for borrowing costs. The Standard specifies that the "capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted". The standard amplifies that the borrowings costs may be incurred during an extended period in which the activities necessary to prepare the asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. The capitalisation of borrowing costs is also not suspended when there is a temporary delay that is a necessary part of the process of getting the asset ready for its intended use or sale. For example, capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high levels are common during the construction period in the geographic region involved. Therefore, capitalisation of borrowing cost is suspended for the period for which active development had been interrupted.

(b) Monetary items and its treatment on balance sheet date: AS 11 on "Accounting for the Effects of Changes in Foreign Exchange Rates", defines, monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money, for example, cash, receivables, payables, etc. Regarding foreign currency transactions, AS 11 requires that while reporting effects of changes in exchange rates subsequent to initial recognition, "at each balance sheet date, monetary items denominated in a foreign currency (e.g. foreign currency notes, balances in bank accounts denominated in a foreign currency, and receivables, payables and loans denominated in a foreign currency) should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from, or required to disburse, such item at the balance sheet date. Regarding transaction of the financial statements of foreign branches, it requires that, "monetary items should be translated using the closing rate. However, in circumstances where the closing rate does not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, the foreign currency item at the balance sheet date, a rate that reflects approximately the likely realisation or disbursement as aforesaid should be used". At every balance sheet date, monetary items denominated in foreign currency should be reported using the closing rate. However, if the closing rate does not sufficiently reflect the recoverability of the amounts, e.g. in case of restrictions on remittance or where the closing rate is unrealistic, the same should be disclosed at the amount which is likely to be realised.

(c) **Changing in Accounting Policies:** As per AS 1 on, "Disclosure of Accounting Policies", the accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements. Every enterprise that prepares financial statements has to follow acceptable accounting policies. As per Accounting Standard-5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" an accounting policy adopted by an enterprise can be changed if the following conditions are fulfilled:

- the change is required by statute;
- the change is required by another accounting standard; or
- if, in the opinion of the management, following the new accounting policy would result in a more appropriate preparation or presentation of the financial statements.

A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise.

Any change in an accounting policy, which has a material effect, should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

(d) AS 18, on "Related Party Disclosure" defines the term "Key management personnel" as "those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise." It has also been clarified in the Standard that in the case of a company, the managing director(s), whole time director(s), manager and any person in accordance with whose directions for instructions the Board of Directors of the company is accustomed to act, are usually considered key management personnel. The concept of 'key management personnel' is very important in the reporting of transactions with related parties. As far as the reporting as per the Standards concerned, it requires disclosures of transactions between related parties during the existence of relating party relationships inter alia the name of the transacting related party; description of the relationship between the parties; volume of the transaction, etc.

(e) Foreign Currency Monetary Items and its Treatment on Balance Sheet date: As per AS 11 on "Accounting for the Effects of Changes in Foreign Exchange Rates" monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money, e.g., cash, receivable, payables, etc. Regarding foreign currency transactions, AS 11 requires that while reporting effects of changes in exchange rates subsequent to initial recognition, at each balance sheet date, monetary items denominated in a foreign currency, (e.g., foreign currency notes, balances in bank accounts denominated in a foreign currency, and receivables, payables and loans denominated in a foreign currency) should be reported using the closing rate prevailing on balance sheet date. However in certain circumstances the closing rate may not reflect, with reasonable accuracy, the amount in reporting currency that is likely to be realized from or required to be disbursed to because the rate is unrealistic. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realized from or required to be disbursed to at the balance sheet date.

(f) **Effect of uncertainties on Revenue recognition:** Para 9 of AS 9 "Revenue Recognition" deals with the effect of uncertainties on revenue recognition. The Para states:

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

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

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

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

Question 2

As a statutory auditor for the year ended 31st March 2002, how would you deal with the following?

(a) As on 31/3/2001, the equity share capital of Q Ltd. is 10 crores divided into shares of Rs.10 each. During the financial year 2001/02, it has issued bonus shares in the ratio of 1:1. The net profit after tax for the years 31/3/2001and 31/3/2002 is Rs.8.50 crores and Rs.11.50 crores respectively. The Earnings per Share (EPS) disclosed in the accounts for two years is Rs.8.50 and Rs.5.75 respectively. (5 Marks)

(b) R Ltd., has borrowed Rs.25 crores from financial institutions during the financial year 2001/02. These borrowings are used to invest in shares of A Ltd., a subsidiary company which is implementing a new project estimated to cost Rs.50 crores. As on 31st March 2002, since the said project was not yet complete, the directors of R Ltd. resolved to capitalize the interest on the borrowings amounting to Rs.3 crores and add it to the cost of investments. (5 Marks)

(c) S Ltd., a listed company, was incurring heavy losses since the last several years and the industry in which it was functioning was not expected to perform better in the next few years. While finalising the accounts for the year ended 31st March 2002, the CFO of the company decided to create a Deferred Tax Asset for the tax benefits that would arise in future years from the earlier years losses that had remained unabsorbed in Income tax. (5 Marks) (Final Nov 2002)

Answer

(a) Disclosure of Earnings Per Share: AS 20 on Earnings Per Share (EPS) prescribes principles for the determination and presentation of earnings per share. As per AS 20, the earnings per share have to be disclosed as basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share in the net profit for the period. In the instant case, both the basic as well as the diluted earnings per share would be the same since there are no dilutive instruments that have been issued by the company. As per the Standard, in the case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The Standard further requires that the number of equity shares outstanding before the event of a bonus issue have to be adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. The standard also explains how the earnings per share is to be calculated in the case of a bonus issue of shares.

In view of the above, the earnings per share for both the years will have to be calculated taking the equity share capital after the bonus issue as the denominator. If the same is done the earnings per share for 31/3/2001 will be Rs.4.25 and that for 31/3/2002 will be Rs.5.75. Since the above figures of earnings per share have not been disclosed, the company has not complied with the provisions of the standard. If the same is not followed, he would then have to qualify his report in terms of section 227 (3) (d) of the Companies Act, 1956.

(b) Capitalisation of Interest on Borrowings in respect of Investments: As per Accounting Standard 13 on "Accounting for Investments", the cost of investment includes acquisition charges such as brokerage, fees and duties. In the instant case, R Ltd. has used borrowed funds for making investment in shares of a subsidiary company. For acquiring shares of a subsidiary company, apart from any fees, duties etc there are no cost incurred for investing in shares. Hence, any borrowing costs incurred cannot be treated as part of cost of investments and cannot be added to the cost of investments. The Accounting Standard 16 on "Borrowing Costs" also does not consider investment in shares as qualifying assets that can enable a company to add the borrowing costs to investments. In the instant case therefore, the statutory auditor would qualify his report by stating that the borrowing costs have been wrongly added to the cost of investments rather than charging them to the profit and loss account. The effect of the same on the profit for the year would also have to be mentioned in the audit report.

(c) Recognition of Deferred Tax Assets: Accounting Standard 22 on "Accounting for Taxes on Income", requires that deferred tax should be recognised for all timing differences, subject to the considerations of prudence in respect of deferred tax assets. The standard further states that where an enterprise has unabsorbed depreciation or carry forward of losses under the tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised. In this context, virtual certainty supported by convincing evidence would mean that there is a reasonable certainty that the carry forward losses would be recouped in the future years. In the instant case, looking to the fact that the industry in which the company was functioning was not expected to perform well in the next few years, getting virtual certainty and convincing evidence for the same would be almost impossible. Hence, in the absence of virtual certainty for offset of the losses in future years, creating a deferred tax asset would not be possible for the company. The statutory auditor would therefore have to qualify his report by stating that deferred tax assets have been created though there is no virtual certainty for getting the said benefit in income tax. He would also have to mention the amount by which the loss for the year has been understated and the amount by which the reserves are overstated.

Question 3

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

A husband and wife are controlling 34% of voting power in XY Company Limited. They are having a separate partnership firm, which supplies mainly the raw material to the Company. The Management says that the above transaction need not be disclosed.

(5 Marks)(Final Nov 2003)

Answer

Disclosure of Transactions with Related Parties: AS 18, "Related Party Disclosures", if applicable, requires disclosure of related party relationships and transactions between a reporting enterprise and its related parties. The parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. The control can be exercised through controlling the composition of the Board or more than half of voting power or substantial interest in the voting power and the power to direct financial and/or operating policies. Significant influence can be exercised through several ways, e.g., participation in financial/operating policies, material inter-company transaction, etc. However as per the explanation given in the Standard, significant influence is said to exist in case the investing party has 20% or more voting power of the enterprise unless it can be demonstrated that this is not the case. As per the facts given, in the absence of other circumstances, it appears that husband and wife will be in a position to exercise significant influence since they are holding 34% of voting power in the company. Hence, relationship as well as nature of transactions would have to be disclosed. In case of non-disclosure, the auditor should qualify the audit report.

Question 4

An old car of a company having a nominal book value has found a buyer, who is willing to pay Rs. 1 lakh for it. The company proposes not to sell the car, but to neglect its valuation in its accounts at Rs. 1 lakh. Should the auditor permit the company to do so? (8 Marks)(Final Nov 2003)

Answer

Revaluation of Car: The old car formed part of the fixed assets of the company and ordinarily the same should be valued at actual cost less depreciation written off. The market price of any of such assets is not relevant for balance sheet valuation of a going concern. However, there is no prohibition in law for revaluation of fixed assets. The accounting principle also allows revaluation, to reflect the fixed assets at their replacement cost. But when all other assets are presumably shown at historical cost, revaluation only of one motorcar seems illogical and has the effect of distorting the overall view of the accounts. Further, revaluation should be carried out on the basis of proper appraisal, normally undertaken by competent valuers. AS 10, "Accounting for Fixed Assets" also clarifies that selective revaluation of assets can lead to unrepresentative amounts being reported in financial statements. Accordingly, when revaluations do not cover all the assets of a given class, it is appropriate that the selection of assets to be revalued be made on a systematic basis. For example, an enterprise may revalue a whole class of assets within a unit. Thus, as per AS 10, when a fixed asset is revalued in financial statements, an entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis. This basis should be disclosed. In the present case, there is no proper appraisal and a revaluation based on one stray bid is not proper to establish a proper replacement value of an antiquated item of asset. The willingness of a buyer to pay the particular price is not logical basis to work out the value of the asset. Because, by this process it may happen that the net book value of the assets might be greater than the recoverable amount of the asset. Therefore, the company though proposes not to sell the car at Rs. One lakh yet it has decided to neglect its value in the accounts. In view of the fact that the company has been taking proper step, the auditor should permit the company to neglect the valuation of car in the accounts because it is in accordance with the relevant requirements of the accounting standards.

Question 5

What are your views on the following?

(a) *A Ltd. was under audit for the year-ended 31.03.2004. An appeal filed by A Ltd. against the demand of Excise Duty of Rs. 26 crores was pending before the Supreme Court for which neither provision was made nor was disclosed in the notes to the financial statements. On 12th July, 2004, the auditor came to know through paper reports that the point involved in the appeal of A Ltd. was adjudicated by the Supreme Court in the case of some other assessee, which is in favour of the department of Excise Duty. The auditor insisted that provisions be made of Rs. 26 crores in the financial statements. The Management was of the view that since its own case is still pending, no provision is called for. It was also of the view that the event does not have any effect on the financial position of the company on the date of the Balance Sheet. Is the view of the Management tenable?* *(5 Marks)*

(b) *Kevin Industries Ltd. has a paid up capital of Rs. 20 crores divided into equity shares of Rs. 10 each as on 31.03.2003. During the financial year 2003-04 it has issued bonus shares in the ratio 1: 1. The net profit after tax for the years 31-03.2003 and 31.3.2004 is Rs. 10 crores and Rs. 15 crores respectively. The Earnings Per Share (EPS) disclosed in the financial statements for the above two years is Rs. 5.00 and Rs. 3.75 respectively. Is the disclosure correct?* *(5 Marks)*

(c) *A firm of a father and a son is receiving Rs. 2 lakhs towards job work done for XYZ Ltd. during the year ended on 31.03.04. The total job work charges paid by XYZ Ltd. during the are over Rs. 50 lakhs. The father is a Managing Director of XYZ Ltd. having substantial holding. The Managing Director told the auditor that since he is not involved in the activities of the firm and since the amount paid to it is* *insignificant; there is no need to disclose the transaction. He further contended that such a payment made in the last year was not disclosed. Is Managing Director right in his approach? (5 Marks)(Final Nov 2004)*

Answer

(a) Subsequent Events: Accounting Standard- 4 on "Contingencies and Events Occurring After the Balance Sheet Date" deals with all those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors of the company. As per AS 4, those events can be identified as adjustable events, which provide further evidence of conditions that existed at the balance sheet date; and non-adjustable events are those, which are indicative of conditions that arise subsequent to the Balance Sheet Date. AAS 19 (SA 560) on "Subsequent Events" lays down that the "auditor should consider the effect of subsequent events on the financial statements and on the auditor's report". In the instant case, A Ltd. had a pending demand of Rs. 26 crores made by the Excise Department for which appeal was made in the Supreme Court. Since the issue involved in the appeal of A Ltd. was similar to the point in case of some other company and since the appeal of that company was decided against that company and in favour of the Excise Department, it is necessary for A Ltd. to make a provision of Rs. 26 crores. The case settled by the Supreme Court on similar point reflects significant developments affecting the assessment about the potential risk faced by the company. The view of the management that its own appeal is undecided or that it has no effect on the financial position as on 31.03.2004 is not at all tenable. Since the financial position is materially affected, the auditor should express a qualified opinion or an adverse opinion as may be appropriate.

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

As on 31.03.2003 $\frac{\text{Protifs}}{\text{Adjusted No. of Shares}}$ = Adjusted EPS

$$\frac{10,00,00,000}{4,00,00,000} = \text{Rs. } 2.5$$

As on 31.03.2004 $\frac{\text{Protifs}}{\text{No. of Shares}}$ = EPS

$$\frac{15,00,00,000}{4,00,00,000} = \text{Rs. } 3.75$$

Since the above figures of EPS have not been disclosed, Kevin Industries Ltd. has not complied with the provisions of AS 20. Therefore, the auditor would have to qualify his report in terms of section 227(3)(d) of the Companies Act, 1956.

(c) Related Party Transactions: Accounting Standard 18, "Related Party Disclosures" applies to the facts of the case. AS 18 requires disclosure of party relationship and transactions between a reporting enterprise and its related parties. The parties are considered to be related if at any time during the reporting period, one party has the ability to control the other party or exercise significant influence over the other party in making decisions. As per the explanation given in AS 18, significant influence is said to exist in case the investing party has 20% or more voting power in the enterprise. In the instant case, the managing director of XYZ Ltd. is a partner in the firm with his son, which has been paid Rs. 2 lakhs as job work charges. The managing director is having a substantial holding in the firm. The case is squarely covered by AS 18. The approach of the managing director is not tenable under the law and accordingly all disclosure requirements have to be complied. Accordingly, the approach followed by the Managing Director is not right. Under the circumstances, the auditor shall have to modify his report. Also it has to be seen whether section 299 regarding disclosure of interest by interested directors has been complied with. If it is not complied with, the auditor needs to modify the report appropriately

Question 6

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

(a) Trimurthy Pan Masala (P) Ltd. was incurring heavy losses in the last several years since it could not withstand the competition in the market. The State in which the company had its registered office and also its major sales had moved a bill in the State Assembly to ban manufacture and sale of all kinds of Pan Masalas in the State. While finalizing the accounts for the year ended 31-03-2004, the CFO of the company created a Deferred Tax Asset for the tax benefits that would arise in future years from the earlier years losses that had remained unabsorbed in Income Tax. (4 Marks)

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

Answer

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

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

Question 7

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

(a) *P Pvt. Ltd. was amalgamated with PQR Ltd. with effect from 1st April, 2004. As per the scheme of amalgamation approved by the High Court, the amalgamation was to be accounted by the "Pooling of Interests Method". The scheme further provided that the balance in Revaluation Reserve of P Pvt. Ltd. as on 31st March, 2004 was to be treated as a General Reserve on amalgamation. During the financial year 2004-05, PQR Ltd. issued bonus shares out of General Reserves (which included the amount of revaluation reserve of P Pvt. Ltd.). (5 Marks)* *(b) B Pvt. Ltd., implements a Voluntary Retirement Scheme (VRS) for its employees. It follows a policy of amortising the expenditure over 10 years. As at 1st April 2004, the unamortised VRS expenditure was Rs. 15 lakhs. During the year 2004-05, it incurred further Rs. 12 lakhs as VRS. For the year ended 31st March 2005, the company proposes to revise the period of amortisation to 5 years. It also proposes to follow the revised period for the opening balance. (5 Marks)(Final May 2005)*

Answer

(a) Amalgamation and Revaluation Reserve: As per AS 14, "Accounting for Amalgamations" if the amalgamation is in the nature of merger and the 'Pooling of Interest Method' is followed, the identity of the reserves is preserved and it appears in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. In the instant case, P Pvt. Ltd is amalgamated with PQR Ltd. and the amalgamation is in the nature of merger. Accordingly, Revaluation Reserves of P Pvt. Ltd. would have normally continued to remain so in PQR Ltd. However, since the scheme mentions that Revaluation Reserve is to be treated as General Reserves, the scheme will override AS 14. AS 14, "Accounting for Amalgamations", also requires that in case of any approved scheme of amalgamation if the treatment in accounting is not as per the AS, a specific disclosure of the same will have to be made along with the financial effect on the financial statements due to such deviation. The statutory auditor will accordingly have to ensure that the company complies with the requirements regarding treatment of reserves and other related disclosure requirements or he may be required to modify his report.

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

Question 8

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

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

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

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

Answer

(a) Capitalisation of Borrowing Costs: Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for intended use or sale are interrupted. According to AS 16, "Borrowing Costs", capitalisation of such borrowing costs should be suspended during extended periods in which active development is interrupted. The standard, however, clarifies that capitalisation of borrowing costs is not suspended when a temporary delay is necessary as a part of the process or substantial technical and administrative work is being carried out. Thus, the test as to whether or not to capitalise the borrowing costs depends primarily upon the nature of interruption of activities during "extended periods".

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

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

As per the clarification issued by ICAI, the use of the word "enterprise" in the above definition clearly implies that the transfers within the enterprise cannot be considered as fulfilling the definition of the term "revenue". Thus, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with AS 9. Further, in case of inter-divisional transfers, risks and rewards remain within the enterprise and also there is no consideration from the point of view of the enterprise as a whole. Thus, the recognition criteria for revenue recognition are also not fulfilled in respect of inter-divisional transfers.

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

(c) Applicability of Accounting Standard: AS 20, "Earning Per Share", came into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. As such AS 20 does not mandate an enterprise, which has neither equity shares nor potential equity shares which are so listed, to calculate and disclose earnings per share, but, if that enterprise discloses earnings per share for complying with the requirements of any statute or otherwise, it should calculate and disclose earnings per share in accordance with AS 20. Part IV of Schedule VI to the Companies, Act, 1956, requires, among other things, disclosure of earnings per share. Accordingly, every company, which is required to give information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

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

Question 9

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

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

(b) XYZ Ltd. had received a grant of Rs. 50 lacs in 1997 from a State Government towards installation of pollution control machinery on fulfillment of certain conditions.

The company, however, failed to comply with the said conditions and consequently was required to refund the said amount in 2005.

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

(c) C Ltd. holds shares of D Ltd. which also entitles it to 51% voting power. These shares are held as "Stock-in-Trade" since C Ltd.'s intention is to dispose them in the near future. Due to this, C Ltd. Is of the view that the financial statements of D Ltd. need not be consolidated. *(4 Marks)(Final May 2006)*

Answer

(a) Stock Exchange Membership Rights: A Pvt. Ltd. has paid Rs.110 lacs for acquiring membership of stock exchange. Such membership rights provide exclusive right to A Pvt. Ltd. for carrying out stock broking activities. Thus, Stock Exchange Membership Rights are controlled by A Pvt. Ltd. and provide the basis for generating economic benefits to it. All these criteria appear to meet the definition of intangible assets as laid down in AS 26, "Intangible Assets". The Standard requires an entity to recognize an intangible asset if it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise and the cost of the asset can be measured reliably. In the instant case, membership rights of stock exchange acquired by A Pvt. Ltd. meet the criteria of identifiability, control and arising of future benefits as well as reliability of the amount of cost. Thus recognizing the membership rights as Fixed Assets is proper.

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

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

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

(c) Consolidation of Accounts: AS 21, "Consolidated Financial Statements", requires that a subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future. In this case it needs consideration as to whether C Ltd.'s intention is to dispose off shares or hold the same. Since shares are being held as 'stock-in-trade' and the intention is to dispose off in near future, it is quite clear that control is temporary. Accounting Standards Interpretation issued by the Institute of Chartered Accountants of India specifies that where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise would be considered temporary. Hence in a such a case the concerned subsidiary should be excluded from consolidation. Therefore, the contention of the C Ltd. that D Ltd. can be excluded from consolidation is correct.

Question 10

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

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

Answer

Accounting for Government Grants (AS 12): According to AS 12 where Government grant is received for the acquisition of a specific fixed assets, the same can not be credited to Profits and Loss Account. It fails to match revenue with the cost. As per AS 12, it should be presented in the Balance Sheet showing the grant as a deduction from the gross value of the asset concerned in arriving at its book value. Alternatively, the Government grants related to a depreciable fixed asset may be treated as deferred income which should be recognised in the Profit and Loss Account on a systematic and rational basis over the useful life of the asset. By crediting the entire amount of grant to Profit and Loss Accounts the company has treated it as a revenue income which is not in accordance with the requirements of the accounting standard. Therefore, the statutory auditor would have to qualify the impact that the income has been overstated to appropriately that extent in qualifying the audit report. Qualify appropriate stated that income has been over stated to the extent of the amount of grant net of proportionate credit that would have been worked out.

Question 11

What are the major differences between Financial and Operational Auditing?

(8 Marks) (Final May 2008)

Answer

The major differences between financial and operational auditing can be described as follows:

(i) Purpose: The financial auditing is basically concerned with the opinion that whether the historical information recorded is correct or not, whereas the operational auditing emphasizes on effectiveness and efficiency of operations for future performance.

(ii) Area: Financial audits are restricted to the matters directly affecting the appropriateness of the presented financial statements whereas the operational audit covers all the activities that are related to efficiency and effectiveness of operations directed towards accomplishment of objectives of organisation.

(iii) Reporting: The financial audit report is sent to all stock holders, bankers and other persons having interest in the organisation. However, the operational audit report is primarily for the management.

(iv) End task :The financial audit has reporting the findings to the persons getting the repost as its end objectives, however, the operational audit is not limited to the reporting only, but includes suggestions for improvements also.

The main objective of operational auditing is to verify the fulfillment of plans, and sound business requirements. Operational auditing is considered as specialized management information tool. Operational auditing is essentially a function of internal auditing staff. Operational auditing is a systematic process of evaluating an organisation's effectiveness, efficiency and economy of operations under management control and reporting to appropriate persons, the result of the evaluation along with recommendations for improvements. Operational audit concentrates on effectiveness, efficiency and economy of operations and therefore it is future oriented. It does not end with the reporting of the findings but also recommends the steps for improvements in future. Operational auditing is not different from internal auditing, it is merely an extension of internal auditing into operational areas.

While in financial auditing, the concentration is more in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are minimized or removed. In financial auditing, an auditor is called upon to review the financial statements of an enterprise to ascertain whether they reflect true and fair view of its state of affairs and of its working results. He may analyse the operations of an enterprise to appraise their cost effectiveness and also he may seek evidence to review the managerial performances.

Question 12

Write a short note on - Integral Foreign Operations. *(4 Marks) (Final May 2008)*

Answer

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

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

NOTE

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