

PAPER – 3 : ADVANCED AUDITING

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

Question 1

As a Statutory auditor, how would you deal with following?

- (a) While finalizing its accounts, a company does not provide for Income-tax payable under the provisions of the Income-tax Act, 1961. A note is however given that since adequate tax has been deducted at source, no additional tax is payable.
- (b) A company receives a grant from the State Government as compensation for loss of stocks due to unseasonal floods. The entire grant received is credited to "Capital Reserve".
- (c) A company which satisfies the conditions of a Small and Medium sized Company (SMC) as per Companies (Accounting Standards) Rules, 2006 has represented that it does not require to give disclosures required by AS-3 "Cash Flow Statements" and AS-18 "Related Party Disclosures" in its financial statements.
- (d) A company which has presented its quarterly results for a limited review report, has represented that expenditure incurred on heavy repairs carried in that quarter are being spread over the entire year, since it would otherwise, distort the quarterly results.

(5+5+4+4 = 18 Marks)

Answer

- (a) Expl.:- The Council of the Institute of Chartered Accounts of India has expressed its view in the Guidance Note on provision for liability for taxation, that provision for anticipated tax liability in respect of profits of the company has to be made while finalizing its accounts. According to it, non-provision for taxation would amount to contravention of the provisions of Sec. 209 and 211 of the Companies Act i.e. maintenance of proper books of account and disclosures of true and fair view of the state of affairs of the company. Accordingly, non-provision for taxation would amount of contravention of the above provision of the Companies Act, 1956.

Conclusion : Hence, in the given case, it is necessary for the auditor to qualify his report and such qualification should bring out in what manner the accounts do not disclose "A true and Fair "view of the state of affairs of the Company and its Profit or loss

However, the qualification should also mention clearly that tax deducted at source is in excess of the estimated tax liability for the year.

- (b) Accounting of Government Grants: Expl: Government Grants related to revenue should be recognized on a systematic basis in the profit and loss Account over the periods necessary to match them with the related costs which they are intended to compensate.

Such Grants should either be shown separately under 'Other Income' in the profit & loss account or should be deducted in reporting the related expenses or losses, if such Grant is received in the same year in which loss is sustained.

In case of such Grant is received towards re-imbursement of losses of past years, the same should be credited to Profit & loss Account under the head 'other Income', Showing separately.

Conclusion: Thus, in the instant case, Grant received by the company from State Govt. as compensation for loss of stocks due to unseasonal floods, and credited to Capital reserve is wrong. In no case, it can be credited to 'CAPITAL RESERVE'. The Auditor should give qualified report.

- (c) Compliance of AS-3 and AS-18 by SMC: Expl:- As per the Companies (Accounting Standards) Rules, 2006, Compliance of Certain Accounting Standards is not mandatory, but optional.

Conclusion: AS-3, as per the above Rules in the initial paragraph mentions that AS-3 (cash flow statement) is not mandatory for SMC.

However, AS-18 does not contain any such mention in the entire Standard. Thus the company, even if it is a SMC, will have to give disclosures for:

(i) related party relationships, and (ii) transactions between a reporting enterprise and its related parties.

- (d) Presentation of Quarterly Results (AS-25): Expl:- presentation of quarterly results is governed by the provisions of AS-25, "Interim Financial Reporting" according to which it is mandatory for all entities preparing Interim Financial Report. Uniform accounting policies are to be applied in interim and annual financial statements. It further says that uneven costs can also be anticipated or deferred only if appropriate to do so at the end of the year.

Conclusion :- In the instant case, in view of the above, as stated in AS-25, heavy repairs can not be deferred to other quarters. If so done by the company, the limited review report will have to contain a qualification for the same.

Question 2

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.
- (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.
- (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.
- (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. (5+5+4+4= 18 Marks)

Answer

- (a) Coercive Method for Sanction of Loan

Provisions: Sec. 21 of the Chartered Accounts Act, 1949, deals with provisions relating to "Other Misconduct".

Supreme Court has observed in the matter of professional things relating to the members of the Institute of Chartered Accountants of India that when a member is prima-facie found guilty of any conduct, the Council of the institute is empowered to conduct an inquiry in the affairs of the conduct and can take action against such member even if no specific provisions are made under Schedules of the Chartered Accountant Act.

In the circumstances, a chartered accountant can be held guilty under the clause of "Other Misconduct" who has opted coercive methods on a Bank for having a loan sanctioned to him.

Conclusion: Thus in the instant case, Mr. P a chartered accountant and proprietor of M/s P & Co. when offers free services of filing Income tax returns of the staff and manager of the Bank for having sanctioned him a loan of Rs. 10 lacs, is clearly hit by clause of 'Other Misconduct' and is deemed to be guilty of professional misconduct, as 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 non professional work would expose him to disciplinary action.

- (c) Excessive Fees: Expl.:- The matter of fixation of actual fees charged in individual cases, depends upon the mutual agreements and understanding between chartered accountant and client. The scales of fees recommended by the council of the Institute is only recommendatory.

Conclusion: In the circumstances, the contention of the client of Mr. M that he has charged an excessive fees for a professional assignment, does not constitute professional misconduct in the context of the provisions of Chartered Accountants Act, 1949 and regulations made thereunder.

In view of the above Mr. M is not liable for any professional misconduct under the Chartered Accountants Act, 1949.

- (c) Editorship of Stock Market and Mutual Funds Journal : Expl.: Clause 11, Part 1 of the first schedule of the Chartered Accountants Act 1949, has mentioned very clearly that a chartered accountant in practice should not engage himself in any other business or occupation other than the profession of accountancy except with the permission granted in accordance with a resolution of the Council. This provision is introduced with a intension to restrain a member in practice from engaging himself in any other business in conjunction with the profession of accountancy and combining such wok with any business, which is not in keeping with dignity of the profession.

Under the above clause, the council permits (among other things) editorship of professional journal.

Conclusion: In the instance case Mr. A, a chartered accountant in practice, has been appointed editor of a journal related to stock market and mutual fund schemes which can not be, in any case, called a professional journal. Hence Mr. A would be guilty of professional misconduct.

- (d) Fees received on a Progressive Basis:Expl. : As per Sec. 226, clause (d) of Sub-section 3, of the Companies Act, 1956 a person indebted to Company for an amount exceeding Rs. 1000/- or a person who has given my guarantee or providing 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 of the Company.

However, where auditor, in terms of his appointment, for various professional work and assignment, recovers fees on progressive basis against such assignments as and when part work is done, without waiting for completion of the whole Job or assignment, the Research Committee of the Institute has observed that where, in terms of resolution passed by General meeting, where auditor received fees/remuneration on progressive basis before completion of his job or assignments, he can not be said to be indebted to the Company at any stage.

Conclusion. : Accordingly, M/s. P Q R, a firm of Chartered Accountant is well within the ambit of laws, even if the firm receives Rs. 50,000/- as part of their audit fees, though the audit report is yet to be submitted and hence, there is no professional misconduct on the part of M/ s. P Q R and the firm can not be called indebted to the Company as per the view of the Research Committee of ICAI.

Question 3

- (a) Auditor's liability to third parties in relation to issue of Prospectus.
- (b) What are the duties of an auditor regarding disqualification of directors under Section 274(1)(g) of the Companies Act, 1956? (8+8 = 16 Marks)

Answer

- (a) Auditor's Liability to Third Party in Relation to issue of Prospectus: The Guidance Note was issued by Company Law Committee in 1985, on Reports of Company Prospectus. Accordingly, the Companies Act, 1956, introduced stringent requirements which the Companies were required to comply with whenever they intended to offer shares or debentures for public subscription, so that the prospective investors in companies make their decision on the basis of proper and adequate information. The requirements, inter alia, included certain reports to be given by the Chartered Accountants about the Companies to the Investors.

Sec. 62 of the Companies Act, 1956, lays down the civil liability for mis-statement in a prospectus, issued to invite persons to subscribe for shares or debentures of a company. The professional accountant will, in such case, be liable to pay compensation to every person who subscribed 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, a professional accountant will not be liable to third parties in relation to issue of Prospectus if he 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. He would withdraw his consent by writing to the company, to the Registrar of Companies, to the stock exchange and through suitable press publicity.
 - (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 or debentures, on becoming aware of the untrue misleading statement, he withdrew his consent in writing and gave reasonable public notice of his withdrawal and of the reasons thereof, or
 - (d) He was competent to make the statement and that he had reasonable grounds to believe up to the time of allotment of the shares or debentures that the statement was true.
- (b) Duties of an auditor regarding Disqualification of Directors U/S 274 (1G) of The Companies Act, 1956: U/s. Sec. 227(3) (f), of the Companies Act, 1956, it is mentioned that the auditor's report shall state whether any director is disqualified from being appointed as a director under clause (G) of Sub-Section (1) of Sec. 274.

In order to report upon clause (f) of Sub-Sec. (3) of Sec. 227 of the Companies Act, 1956, it is essential that the auditor understands the requirements of clause (G) of sub-sec. 1) of Sec. 274 of the companies Act which states :

That 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 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 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. 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 or has failed to repay its deposit or interest or redeem its debentures on due date or pay dividend.

Auditor to comply with Sec. 227(3)(F), should obtain a written representation as to :

- (a) Names of directors of the Company during period covered by the auditor's report.
- (b) Particulars of appointment/re-appointment or resignation/ retirement of such directors.
- (c) Submission of Form DD-A, required to be submitted by such director.
- (d) Information of directors contained in the register of directors U /s. 303(1) of companies Act as updated upto the date of balance sheet.
- (e) Details of default committed by the Company U/s. 274(1) of the Act.
- (f) In case of above default, whether the Company has furnished the form DD-B as required by the Rules.

On the basis of such examination the auditor is required to furnish certificate every year stating therein whether any director is disqualified for appointment as director.

Question 4

- (a) 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.
- (b) 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+8 = 16 Marks)

Answer

- (a) Default in Compliance of Section 58 AA : As per paragraph 4 (vi) of the Companies (Auditor's report) order 2003 as amended companies (Auditor's report) amendment order (2004), the audit report should include the following matters with regard to public deposits.

In case, the company has accepted deposits from the public, whether the directives issued by RBI and the provisions of Sec 58 A and 58 AA or any other relevant provisions of the Act and rules framed thereunder, where 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 Company Law Tribunal or RBI or any other Court or any other Tribunal, whether the same has been complied with or not.

Sec. 58 AA deals with small depositors. A small depositor is a depositor who has deposited in a financial year, a sum not exceeding Rs. 20,000/- in the Company. Non-Compliance of Sec. 58 AA occurs where Company fails to intimate Company Law Board any default in repayment of deposit to small depositors or part thereof or any interest thereupon. The auditor has, therefore, to first determine whether there is any default in repayment of such deposits. When number of such depositors are large, it may not be feasible for the auditor to first Verify each amount of default in repayment. The auditor, in such case, should examine the internal control in this regard and determine its efficacy. The auditor should obtain a schedule of repayment of loans taken from small depositors from the management of the company and should make reasonable test checks of repayments made by the Company. In case the results of test check reveal that the management has defaulted in repayment of deposits made by small depositors or part thereof or interest thereupon, he should examine whether the same has been intimated to the Company law Board. The auditor should also enquire from the management about the possible instances of non compliance with Sec. 58 AA and the relevant rules. The auditor should also enquire from the management about any order passed by the Company Law Board for contravention of Sec, 58 AA and the relevant rules.

The auditor should obtain management representation to the effect whether :

- (a) The company has complied with directives issued by RBI and the provisions of Sec. 58 AA of the Act and
- (b) Where an order has been passed by the Company Law Board, the Company has complied with the requirements of the Order.
- (b) Directions U/S. 619 (3) (A) of The Companies Act, 1956 applicable to Insurance Company :Points on which the statutory Auditor has to report in respect of System of Accounts, are as under :

- (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 accounts
 - (d) Reconciliation of inter-office accounts.
 - (e) Reconciliation of registers I records relating to property, assets, investments, premiums, claims, loans etc. with financial books.
 - (f) Maintenance of up-to-date records in respect of assets which are pledged, encumbered or blocked in any way.
- (2) Are the bank accounts of the Company reconciled with the bank statements regularly? If not, describe the failures.
- (3) Are Control accounts and subsidiary accounts up-to-date and reconciled regularly? If not, describe the failures.
- (4) Examine the accounting policies of the Company. Are these in conformity with the Accounting Standards. Give particular of materials departures from these standard, if any, along with their effect on the financial statements. Quantify the impact wherever possible.

The statutory auditors are required to submit a copy of their report as above to the C & AG, U / s - 619(3) (A) of the companies Act, 1956.

Question 5

- (a) 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)
- (b) What are the Financial indications to be considered by an auditor for evolution of the going Concern assumption? (4 Marks)

Answer

- (a) 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 rupee; 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 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 its turnover does not exceed Rs. 50 crores or borrowings do not exceed Rs. 10 crore. For calculating this turnover, other income is not to be included. Since B Pvt. Ltd. has a turnover of Rs. 45 crores and borrowing; of Rs. 9 crores, it will satisfy the definition and can be classified as 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 Ltd. cannot be classified as a SMC.
- (b) Going Concern Assumption: Indication of risk that continuance as a going concern may be questionable, could come from the financial statements or from other related sources. As per AAS - 16, following are the financial indication to be considered by an auditor for evolution of the Going Concern assumption.
- (i) Negative net worth or negative working capital.
 - (ii) Long term borrowings not being repaid on due dates and without any realistic prospects of renewals or repayment.
 - (iii) Substantial operating losses.
 - (iv) Substantial negative cash flows from operations.
 - (v) Inability to pay creditors on due dates.
 - (vi) Arrears or discontinuance of dividend payments to shareholders.

- (vii) Adverse key financial ratios.
- (viii) Inability to obtain financing for essential new product development.
- (ix) Entering into a scheme of arrangement with creditors for reduction of liability.

Question 6

- (a) How are investments to be classified in the financial statements of a Bank? (8 Marks)
- (b) Discuss the reporting requirement in Form 3CD of Tax Audit Report under Section 44AB of the Income-tax Act, 1961 for the following: (8 Marks)

Answer

- (a) Classification of Investments in case of a Bank : The entire investment portfolio of the bank (including SLR Securities and non - SLR securities) should be classified under three categories.
 - (i) Held to Maturity
 - (ii) Available for sale
 - (iii) Held for Trading.

However, in the balance sheet, the investments will continue to be disclosed as per the existing six classifications viz :

- (i) Govt. Securities
- (ii) Other approved securities
- (iii) Shares
- (iv) Debentures & Bonds.
- (v) Subsidiaries / Joint ventures and
- (vi) 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 upto maturity will be classified under 'Held to maturity'.
- (ii) The investments included under 'held to maturity' should not exceed 25% of the bank's total investments. The banks may include, at their discretion, under 'Held to maturity' category securities less than 25% of total investment.
- (iii) Following investments will be classified under 'Held to maturity' but will not be counted for the purpose of ceiling of 25% specified for this category.
 - (a) Re-capitalization bonds received from the Govt. of India towards their re-capitalization requirement and held in their investment portfolio.

- (b) Investments 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.

Available for Sale : The securities which do not fall within the above two categories will be classified under Available for Sale.

Held for Trading: The Investments classified under this category are the securities acquired by the banks with an intention to trade by taking advantage of the short term price/interest rate movements. These securities are to be sold within 90 days. Profit or loss on sale of investments will be taken to the Profit and Loss Account.

(b) Tax Audit U/s. 44 AB

- (i) Tax Decuted At Source : Under the clause 27(a), following particulars requires to be reported by an auditor on the compliance with the provisions of Chapter XVII-B regarding deduction of tax at source and payment thereof to the credit of the central Govt.

- (a) Whether the assessee has complied with the provision of chapter XVII-B regarding deduction of tax at source and regarding the payment thereof the credit of the Central Govt.

- (b) If the provisions of chapter XVII-B have not been complied with, please give the following details:

	Amount
(i) Tax deductible and not deducted at all	-
(ii) Short fall in account of lesser deduction than required to be deducted	-
(iii) Tax deducted late	-
(iv) Tax deducted but not paid to the credit of the Central Govt.	-

In case, test checking has been done for the above (in case of volumes data), an appropriate disclosure for the same is to be given.

- (ii) Expenditure incurred at club : Under the clause 17(d), the amount of payments made to clubs by the assesses during the year should be indicated. The payments may be for entrance fees as well as membership and subscription and for catering other services by the club, both in respect of directors/partners/proprietor of the organization. The fact whether such expenses are Incurred in the course of business or whether they are of personal nature should be ascertained. If they are of personal nature, they are to be shown separately under clause 17 (b).

Question 7

- (a) What are the areas to be considered in an Environment Audit? (8 Marks)
- (b) 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)

Answer

- (a) Environmental Audit : Environmental Audits are becoming increasingly common in certain industries. Normally, environmental audits are performed at the request of management and are for internal use.

The main areas over which Environmental Audit should be dealt with in respect of various industrial units are as under :

- (i) Layout and Design : Installation of Pollution Control devices, provisions for up gradation of Pollution Control measures to meet requirement of regulation framed by Govt.
- (ii) Management of Resources : It include air, water, land, energy, raw materials and human resources and to see that these resources are interlinked and best used with minimum waste.
- (iii) Pollution Control System : An effective system of pollution control exist and to inquire whether more measures are required, keeping in view the type of industry and its nature or working.
- (iv) Emergent Safety Arrangement :- The Chemical, Gas etc. industries which are prone to sudden requirement of safety arrangements, must remain emergency plans are to be reviewed periodically.
 - (1) Medical and Healthcare facilities : The medical services should be maintained. The health of the workers should be a big consideration for the management.
 - (2) industrial Hygiene : Proper system should be maintained to eliminate industrial unhygienic state.
 - (3) Occupational Health : As the occupational health hazards varies from industry to industry due to the difference in the nature of working atmosphere and the pollution present in it, the concerned industry must pay proper weightage to those diseases which are prone to that particular type of industry.
 - (4) Information Assimilation and Reporting system : Proper information generated and reported by proper distributor of authorities, responsibilities and delegations. A report of compliance of all statutory environmental laws along with other preventive and precautionary measures should be put to Board at regular internals.
 - (5) EIA Methodology : The Environmental Impact Assessment is usually pre-requisite to start an industry. This is done considering the known spheres of

activities on the existing environmental conditions. But the predictions necessarily deviate from the actual happenings when the industry starts working. To accommodate the deviation in the system is also to be incorporated in the EIA report.

- (6) Compliance to the Regulatory mechanism : As the person who are directly working with the system, may be unaware of the latest developments and requirements for the compliance of standards prescribed by the various regulatory authorities, they should be trained and instructed on regular basis, to avoid making the Board/Owner liable to prosecution and penalty.
- (7) Concern of the society: The industry very often transform the agrarian environment into an industrial environment. The people so displaced by industrialization feel alienated, and develop a feeling of facing the gaseous, dutiful, clumsy state of surroundings. The audit should look into this aspect how the industry is making a balance between its own development and the society's concern.

(b) Report to the Management to Compile Financial Statement (Asss – 31)

To,

On the basis of accounting records and other information and explanations provided to us by the management, we have compiled the unaudited Balance sheet of ABC Company limited as at 31st March 2008 and the related Profit & Loss Account for the period then ended on 31st March 2008.

The management of the ABC Company Limited is responsible for :

- (a) Completeness and accuracy of the underlying data and complete disclosures of all material and relevant information's 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.

The compilation engagement was carried out in accordance with AAS-31, as recommended by ICAI.

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

Place:

Date:

For Chartered Accountant

Question 8

Write short notes on any four of the following:

- (a) Investor Protection and Education Fund.
- (b) Contingent liabilities in case of Banks.
- (c) Borrowing costs and Qualifying assets.
- (d) Permanent consolidation adjustments.
- (e) Facultative reinsurance under Insurance Act, 1938.
- (f) Stages in Risk Based Internal Audit.

(4x4 = 16 Marks)

Answer

Short Notes:

- (a) Investor Protection And Education Fund: The Central Govt. has established Fund U /s. 205-C of the Companies Act, 1956, called Investor Protection and Education Fund.

Features of this Fund are :

- (i) The following amount usually are credited to this Fund
 - (a) Unpaid dividend.
 - (b) Application money received by the Company or allotment of securities and due for refund.
 - (c) Matured deposits with Companies.
 - (d) Matured debentures with Companies.
 - (e) The interest accrued on the amounts referred to in (a) to (d).
 - (f) Grants and donations given to the Fund by the Central Govt., State Govt., Companies or any other institutions for the purpose of the fund.
 - (g) The interest or other income received out of the investments made from the Fund.

Provided that no much amounts referred to in clauses (a) to (d) shall form part of the fund unless such amounts have remained unclaimed and unpaid for a period of seven years from the date they become due for payment.

- (i) The Fund shall be utilized for promotion of investor awareness and protection of the interest of the investors.
- (ii) The Central Govt. shall, by notification in the Official Gazette, specify an authority or Committee, with such members as the Central Govt. may appoint, to administer the Fund.

- (iii) It shall be competent for the authority or committee appointed as above to spend moneys out of the Fund for carrying out the object for which the Fund has been established.
- (b) Contingent Liabilities in case of Banks: The Third Schedule to the Banking Regulation Act, 1949, requires the disclosures of the following as a footnote to the balance sheet.
 - (a) (i) Claims against the bank not acknowledged as debts.
 - (ii) Liability for partly paid investments.
 - (iii) Liability account of outstanding forward exchange on contracts.
 - (iv) Guarantees given on behalf of constituents.
 - (a) In India
 - (b) Out side India.
 - (v) Acceptances, endorsements and other obligations.
 - (vi) Other items for which the bank is contingently liable.
- (b) Bills for collection.
- (c) Borrowing costs and qualifying assets (AS 16) : Borrowing cost requires that financial cost relating the deferred credit or borrowed funds, directly attributable to construction, production or acquisition of qualifying assets should also be included in the cost of assets.

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or Sale.
- (d) Permanent consolidation adjustments : Permanent consolidation adjustments are those adjustments that are made only on the first occasion of the preparation and presentation of consolidated financial statements. These adjustments are:
 - (i) Determination of excess or deficit of the cost to the parent of its investments in subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made.
 - (ii) Determination of the amount of equity attributable to minorities at the date on which investment in subsidiary is made; and
 - (iii) Determination of Goodwill or capital reserve arising on application of equity method to account for investment in associates in consolidated financial statements.

Auditor should verify that the above calculations have been made appropriately. The auditor should pay particular attention to the determination of pre-acquisition reserves of the subsidiary and associates. Date(s) of investment in subsidiary and associates assumes importance in this regard. The auditor should also examine whether the pre-acquisition reserves have been allocated appropriately between the parents and minorities of the subsidiary. The auditor should also verify the changes that might have

taken place in these permanent adjustments on account of subsequent acquisition of shares in the subsidiary / associate, disposal of the subsidiary /associate in the subsequent years. Auditor should also check whether Goodwill in one company and Capital Reserve in another company have been netted off while preparing consolidated financial statements.

- (e) Facultative reinsurance under insurance Act, 1938 : It is that type of reinsurance whereby the Contract relates to one particular risk and is expressed in the reinsurance policy. This is the oldest method of re-insurance and is necessitates consideration of each risk separately. Each transaction under facultative reinsurance has to be negotiated individually, Each party to the transaction has a free choice, i.e. for the Ceding Company to offer and the reinsurer to accept. The main drawbacks of this type of insurance are the volume of work involved and time taken to cover the risk. It is used mainly when :
- (i) Automatic covers have already been exhausted
 - (ii) The risk is excluded from the treaties
 - (iii) The insurer does not want his reinsurance treaties overburdened with particularly heavy and abnormal risks.
 - (iv) The insurer has no automatic cover at his disposal in a particular branch, where he issues policies rarely.
 - (v) The nature of business is such that technical guidance or consultation with the reinsurer is required at every stage of acceptance of the risk it itself.
- (f) Audit should be risk-based or focused on areas of greatest risk the achievement of the Audited entity's objectives. Risk-based Internal Audit is an approach to audit that analyzes audit risks, set materiality thresholds, based on audit risk analysis and develops audit programmes that allocate a larger portion of audit resources to high-risk areas.

The auditor does not normally need to perform specific audit procedures on all areas of audit. He only needs to design audit programmes on procedures on areas earlier identified as major risks that could result in the financial statements being materially misstated.

It comprises three stages :

- (i) Assessing Risk maturity
- (ii) Preparing periodic Audit plan.
- (iii) Conducting individual assurance audit assignments and reporting to appropriate levels.