

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

Answer all questions.

Question 1

Comment on the following:

- (a) T Ltd. an Indian company, subject to Indian Income tax Act, 1961, discloses advance Income-tax paid (Current tax asset) and provision for Income-tax (Current tax liability), separately in Balance Sheet for the year ended 31.3.2010, i.e., it does not offset the amount. (5 marks)
- (b) A Private Limited reports the following position as on 31st March, 2010 :

Paid up capital	30 lacs
Revaluation reserve	10 lacs
Capital reserve	11 lacs
P&T A/c [Dr. Balance]	2 lacs

The Management of the Company contends that CARO 2003 is not applicable to it.

(5 marks)

- (c) S Ltd. issued Bonds to the tune of Rs. 100 lacs and provided security to the tune of Rs. 80 lacs for the same. It insists that it will disclose the Bonds as "Secured" in the Balance Sheet of the Company. (5 marks)
- (d) F Limited includes in the Schedule of Inventory, those items of Fixed assets which have not been in active use and held for disposal, as inventory item. (5 marks)

Answer

- (a) As per paragraph 27 of Accounting Standard(AS) 22 – Accounting for Taxes on Income, an enterprise should offset assets and liabilities representing current tax if the enterprise:
- has a legally enforceable right to set off the recognized amounts and
 - intends to settle the asset and liability on a net basis.

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

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

- (b) As per the Statement on CARO, 2003 issued by ICAI, for determining the applicability of the CARO, 2003 to a private limited company, both capital as well as the revenue reserves shall be taken into consideration while computing the limit of rupees fifty lacs

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prescribed for paid up capital and reserves. Revaluation reserve, if any, should also be taken into consideration while determining the figure of reserves for the limited purpose of determining the applicability of the Order. The credit balance in the profit and loss account should also be considered as a part of reserve since the balance in the profit and loss account is available for general purposes like declaration of dividend. The debit balance in the profit and loss account, if any, should be reduced from the figure of revenue reserves only. If the company does not have revenue reserves, debit balance of profit and loss account cannot be reduced from the figures of paid up capital, capital reserve and revaluation reserve.

Accordingly the profit and loss account (Dr Balance) of Rs. 2 lacs cannot be deducted and hence CARO, 2003 is applicable to the Company.

- (c) Prima facie, the Bonds issued to the tune of Rs.100 lacs are provided with security to the tune of Rs. 80 lacs i.e. neither fully secured nor unsecured. Guidance Note on the “Terms used in Financial Statements” issued by ICAI, states “Secured Loans” as loan secured wholly or partly against an asset. Hence the Bonds should be classified under ‘Secured Loans’ for the purpose of disclosure in the Balance Sheet. However the nature of security should be clearly specified.
- (d) AS-10 “Accounting for Fixed Assets”, requires that the items of fixed assets that have been retired from active use and are held for disposal be stated at the lower of their net book value and net realizable value and are shown separately in the financial statements. As per AS-2 “Valuation of Inventories”, “inventories” are assets “held for sale in the ordinary course of business, in the process of production for such sale; or in the form of materials or supplies to be consumed in the production process or in the rendering of services.”, whereas, the sale of fixed assets cannot be treated as sale arising from the ordinary course of business.

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

Question 2

Give your comments with reference to the Chartered Accountants Act, and Schedules thereto:

- (a) *Mr. A, a practicing Chartered Accountant, took over as the executive chairman of Software Company on 1.4.2010. On 10.4.2010 he applied to the Council for permission.*
(4 marks)
- (b) *Mr. X, a practicing Chartered Accountant, issued a circulation certificate for a periodical on the basis of outward memos, which was later found to be false.*
(4 marks)
- (c) *Mr. Z, a practicing Chartered Accountant, received a sum of Rs. 1 lac on 1.9.2009 from a Client who intends to leave abroad for a period of a year, with a request that his advance tax liabilities to be paid over the three instalments. On 15th September, 2009, 15th December, 2009 and 15th March, 2010. After remitting the 1st instalment of advance tax*

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on 15.9.2009, Z did not keep the Balance Money in a separate Bank account and he is of the opinion he will remit the money within reasonable time as per payment schedule of Advance tax. (4 marks)

- (d) *Mr. X, a Chartered Accountant, employed as a paid Assistant with a Chartered Accountant firm. On 31st December, 2008 he leaves the services of the firm. Despite many reminders from ICAI he fails to reply regarding the date of leaving the services of the firm.* (4 marks)

Answer

- (a) As per Clause (11) of Part I of Schedule I of the Chartered Accountant Act, 1949 a Chartered Accountant in practice, will be deemed to be of professional misconduct if he engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage.

Thus, Mr. A took over as the executive chairman on 01/04/2010 and applied for permission on 10/4/2010, on the basis of these facts he was engaged in other occupation between the period 01/04/2010 and 10/04/2010, without the permission of the Council and is guilty of misconduct in terms of this clause.

- (b) As per Clause (8) of Part I of Schedule II of the Chartered Accountant Act, 1949 a Chartered Accountant in practice, will be deemed to be guilty of professional misconduct, if he fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion.

This indicates a Chartered Accountant must determine the extent of information, which, should be obtained by him before he expresses an opinion on the financial statements.

Thus, Mr. X certifies the circulation based on outward memos, without going into the most elementary details of how the circulation of a periodical was maintained, i.e. not verifying the financial records, bank statements, collections for the periodicals, payment of the printer's bills etc. Hence he is guilty of professional misconduct.

- (c) As per Clause (10) of Part I of Schedule II of the Chartered Accountant Act, 1949, a Chartered Accountant in practice will be deemed to be of professional misconduct if he fails to keep moneys of his client other than the fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.

The term reasonable time would depend upon the circumstances of the case. Moneys which are intended to be spent within a reasonably short time need not be put in a separate bank account.

Thus, Mr. Z should have kept the balance money after remitting the first instalment of advance tax into a separate bank account. Hence he is guilty of professional misconduct.

- (d) As per Clause (2) of Part III of the First Schedule a member, whether in practice or not, will be deemed to be guilty of professional misconduct if he does not supply the information called for, or does not comply with the requirements asked for, by the

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Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate authority.

Thus, Mr. X has failed to reply to the letters of the Institute asking him to confirm the date of leaving the service as a paid assistant he is held to be guilty of professional misconduct.

Question 3

- (a) *In the course of audit of ABC Ltd. its management refuses to provide written representations. As an auditor what is your duty?* (4 marks)
- (b) *While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?* (4 marks)
- (c) *What are the auditor's responsibilities in respect of corresponding figures?* (4 marks)
- (d) *IT systems also pose specific risks to an entity's internal control? What are those risks?* (4 marks)

Answer

(a) Duty of an Auditor if management refuses to provide written representations

As per SA 580 (Revised) "Written Representations", if the management does not provide one or more of the requested written representations, the auditor shall:

- (i) Discuss the matter with management
- (ii) Re-evaluate the Integrity of the management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general and
- (iii) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

The auditor should disclaim an opinion on the financial statements if management does not provide written representations.

(b) Risk Factors while applying sampling techniques

As per SA 530(Revised) "Audit Sampling", sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions.

- (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of tests of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
- (ii) In the case of test of controls, the controls are less effective than they actually are, or in the case of tests of details, that a material misstatement exists when in fact it

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does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

(c) Auditor's responsibilities in respect of corresponding figures

As per SA 710 "Comparatives", in respect of corresponding figures,

- (i) The auditor should obtain sufficient appropriate audit evidence that the corresponding figures meet the requirements of the relevant financial reporting framework. The extent of audit procedure performed on the corresponding figures is significantly less than that for the audit of current period figures and is ordinarily limited to ensuring that the corresponding figures have been correctly reported and are appropriately classified. This involves the auditor assessing whether:
 - (a) accounting policies used for corresponding figures are consistent with those of the current period or whether appropriate adjustments and/or disclosures have been made and
 - (b) corresponding figures agree with the amounts and other disclosures presented in the prior period or whether appropriate adjustments and/or disclosures have been made.
- (ii) When the financial statements of the prior period have been audited by another auditor, the incoming auditor should assess whether the corresponding figures meet the conditions specified above.
- (iii) When the financial statements of the prior period have not been audited, the incoming auditor nonetheless should assess whether the corresponding figures meet the conditions specified above.
- (iv) If the auditor becomes aware of a possible material misstatement in the corresponding figures when performing the current period audit, the auditor should perform such additional procedures as are appropriate in the circumstances.

(d) Specific Risk to an Entity's internal Control

As per SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", IT system also poses specific risks to an entity's Internal Control. They are–

- (i) Reliance on systems or programs that are inaccurately processing data, processing inaccurate data or both
- (ii) Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non existent transactions, or inaccurate recording of transactions. Particular risk may arise when multiple users access a common database.
- (iii) The possibility of IT personnel gaining access beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- (iv) Unauthorised changes to data in Master files

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- (v) Unauthorised changes to systems or programs.
- (vi) Failure to make necessary changes to systems or programs.
- (vii) In appropriate manual intervention
- (viii) Potential loss of data or inability to access data as required.

Question 4

- (a) *While auditing the Branch of a Bank you are required to examine Inter Branch adjustments. Which points require your special attention?* (6 marks)
- (b) *How do you examine claims against the Bank not acknowledged as debts?* (4 marks)
- (c) *While auditing the claims paid in respect of a General Insurance Company what aspects need to be looked into?* (6 marks)

Answer

- (a) **Special points to examine Inter Branch adjustments:** The following points require special attention in the examination of Inter Branch transactions.
 - (i) While verifying the closing balance, special attention should be paid to the origin and validity of old outstanding unmatched entries, particularly debit entries. The auditor may also seek confirmation of transactions relating to outstanding in appropriate cases.
 - (ii) Whether there are any reversal entries indicating the possibility of irregular payments or frauds.
 - (iii) Whether the balances include any items in the nature of cash in transit included in this head which remain pending for more than a reasonable period. This is because such items are not expected to remain outstanding beyond a very small period during which they are in transit.
 - (iv) Whether transactions other than those relating to inter branch transactions have been included in inter branch accounts. Any unusual items put through inter branch accounts as well as old or large entries outstanding in Inter branch accounts should be carefully looked into. The auditor should also seek explanations from the Management in this regard in appropriate cases.
- (b) **Examination of claims against the Bank not acknowledged as debts:** The auditor should examine the relevant evidence, for example correspondence with lawyers, claimants, workers/officers and workmen's/officer's unions. The auditor should also review the minutes of the meeting of the Board of directors/committees of the Board, contracts, agreements and arrangements, list of pending legal cases and correspondence relating to taxes, duties etc., to identify claims against the bank. The auditor should ascertain from the management the status of claims outstanding as at the end of previous year. A review of subsequent events would also provide evidence about completeness and valuation of claims.

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- (c) Audit of the claims paid in respect of a General Insurance Company:** The following are the aspects needs to be examined in respect of claims paid:
- (i) In case of co-insurance arrangements, claims paid have been booked only in respect of the company's share and the balance has been debited to other insurance companies.
 - (ii) In case of claims paid on the advices from other insurance companies, (where the company is not the leader in co-insurance arrangements), whether share of premium was also received by the Company. Such claims which have been communicated after the year end for losses which occurred prior to the year end must be accounted for in the year of audit.
 - (iii) Claims paid have been duly authorized and acknowledged by the claimants.
 - (iv) Salvage recovery has been in accordance with the procedure prescribed and a letter of subrogation has been obtained in accordance with the laid down procedure.
 - (v) That the amounts of the nature of pure advances/deposits with Courts, etc., in matters under litigation/arbitration have not been treated as claims paid but are held as assets till final disposal of such claims. In such cases, full provision should be made for outstanding claims.
 - (vi) That payment made against claims partially settled has been duly vouched. In such cases, the sanctioning authority should be the same as the one which has powers in respect of the total claimed amount.
 - (vii) In case of final settlement of claims, the claimant has given unqualified discharge note, not involving the company in any further liability in respect of the claim; and
 - (viii) That the figures of claims, wherever communicated for the year by the Division to the Head Office for purposes of reinsurance claims, have been reconciled with the trial balance-figure.

Question 5

- (a) *What is the purpose served by Introduction of Cost audit?* (4 marks)
- (b) *As auditor of Z Ltd., you would like to limit your examination of account balance tests. What are the control objectives you would like the accounting control system to achieve to suit your purpose?* (4 marks)
- (c) *In the audit planning process of X Ltd., you would like to consider audit risk at the financial statement level. What are the factors can influence your decision?* (3 marks)
- (d) *Explain the liability of the auditor under section 62 of the Companies Act, 1956, for making an untrue statement in the report (as an expert forming a part of the prospectus).* (5 marks)

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Answer

(a) According to the Institute of Cost and Management Accountants of England, cost audit represents the verification of cost accounts and a check on the adherence to cost accounting plan. Cost audit, therefore, comprises:

- (i) verification of the cost accounting records such as the accuracy of the cost accounts, cost reports, cost statements, cost data and costing techniques and
- (ii) examination of these records to ensure that they adhere to the cost accounting principles, plans, procedures and objectives.

The undernoted circumstances may warrant the introduction of cost audit:

- (i) **Price fixation** – The need for fixation of retention prices in the case of materials of national importance, like steel, cement etc., may be useful in knowing the true cost of production.
- (ii) **Cost variation within the industry** -where the cost of production varies significantly from unit to unit in the same industry, cost audit may be necessary to find the reasons for such differences.
- (iii) **Inefficient management** – Where a factory is run inefficiently and uneconomically, institution of cost audit may be necessary. It may be particularly useful for the Government before it takes over any unit.
- (iv) **Tax assessment** – Where a duty or tax is levied on products based on cost of production, the levying authorities may ask for cost audit to determine the correct cost of production.
- (v) **Trade disputes** – Cost audit may be useful in settling trade disputes about claim for higher wages, bonus, etc.

(b) Basic Accounting Control Objectives

The basic accounting control objectives which are sought to be achieved by any accounting control system are:

- (i) Whether all transactions are recorded;
- (ii) Whether recorded transactions are real;
- (iii) Whether all recorded transactions are properly valued;
- (iv) Whether all transactions are recorded timely;
- (v) Whether all transactions are properly posted;
- (vi) Whether all transactions are properly classified and disclosed;
- (vii) Whether all transactions are properly summarized.

(c) Audit risk at financial statement level

The following factors will be considered for determination of audit risk at financial statement level.

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- (i) Integrity of Management.
- (ii) Management experience, knowledge and changes during the period.
- (iii) Unusual pressures on the Management.
- (iv) Nature of entity's business.
- (v) Factors affecting the Industry in which the entity operates.

(d) Liability of the auditor under Section 62 of the Companies Act, 1956

Section 62 of the Companies Act, 1956 deals with civil liability for mis-statements in the prospectus. An Action in this case can be brought by a person who has sustained a loss or damage as a result of subscription to the shares or debentures, on the faith of the prospectus containing an untrue statement

The liability would arise if the written consent of the auditor to the issue of the prospectus, including the report purporting to have been made by him as an "expert" has been obtained.

The action would not succeed if the auditor is able to prove:

- (i) that after he had given his consent in writing, the same was withdrawn before any copy of the prospectus was delivered for registration; or
- (ii) that after registration of the prospectus but before any allotment was made thereunder, he, on realizing that the statement was untrue, had withdrawn his consent in writing and had given reasonable public notice of the withdrawal and of the reasons therefore; or
- (iii) that he was competent to make the statement and that on reasonable ground he believed and had continued to believe upto the time of allotment of shares or debentures that the statement was true.

Question 6

Write short notes on the following:

- (a) *Special points that may be covered in the audit of equipment leasing finance company.* (4 marks)
- (b) *Mark to Market margins.* (4 marks)
- (c) *Major steps required in preparation of Tax audit under VAT.* (5 marks)
- (d) *Focus of a Peer review.* (3 marks)

Answer

(a) Audit of equipment leasing finance company

The auditor should:

- (i) Ascertain whether the Non Banking Financial Companies (NBFC) has an adequate appraisal system for extending equipment leasing finance.

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- (ii) Verify whether there is an adequate system in place for ensuring installation of assets and their periodical physical verification. In some major transactions, 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 that the NBFC has an adequate system for monitoring whether the assets have been adequately insured against and regular maintenance of the leased asset 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 Accounting Standard issued by the Institute of Chartered Accountants of India in respect of “Accounting for Lease” has been compulsorily followed.

(b) Mark to Market Margin (MTM)

MTM margin is the notional loss, which a stock member or his client would incur, if the net cumulative outstanding positions in all securities were closed out at the closing price of the relevant trading day, which is different from the price at which the transaction had been entered into. For each security, this is worked out by multiplying the difference between the closing price and the price at which the trade was executed by the cumulative buy and sell open position (for buy position the close price being lower than actual trade price and for sell position the close price being higher than actual trade price). The aggregate amount computed across all securities is MTM margin payable by a member. The mark-to-market margin is payable with reference to net position at client's level.

(c) Major steps required in preparation of Tax audit under VAT

A tax auditor has to make certain preliminary preparations before the actual execution of tax audit under the VAT law. The major steps required to be undertaken for the preparation are as under:

- (i) **Knowledge of business** : After accepting the audit assignment the auditor should familiarize himself with the business of the auditee. In this regard, the auditor should refer to the SA 315 - “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment” issued by the Council of the Institute of Chartered Accountants of India. Before starting the audit, the auditor should have a preliminary knowledge of the industry/ business and of the nature of ownership, management etc. More detailed information should be obtained and should be assessed and updated during the course of audit. For this purpose the various sources of information may be tapped. The knowledge of business is important not only to the auditor but also to his staff engaged in the audit. The auditor has to ensure that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to carry out the audit work delegated to them and further they should make effective use of the knowledge

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about the business and should consider how it affects the tax liability reported in the return. The facts and figures in the returns should be consistent with the auditor's knowledge of the business. The auditor should also make himself familiar with the process of production and the distribution chain. The auditor should also obtain information about whether the auditee is a manufacturer/ importer/ retailer, the details of major customers to whom the sales are effected and the details of sales which are outside the scope of VAT law. Similarly the sources of purchase and the items sold should be listed out. Further it should be ascertained whether the auditee has opted for the composition scheme or not.

- (ii) **Obtaining a list of all the accounting records maintained by the auditee :** The auditor should obtain a complete list of all the accounting records relating to sale/purchase of goods, stocks, the various registers, the ledgers etc. maintained, in which the transactions are recorded, the various source documents in which the entries are recorded in the books of account and the process of their generation.
- (iii) **Ascertaining the major accounting policies adopted by the auditee :** The auditor should know the major accounting policies based on which books of account have been recorded. The accounting policy regarding recording of sales, purchases and valuation of inventory must be made known and the auditor should also find out whether there has been any change in those policies during the year covered by audit. If there is any significant change in the accounting policy giving rise to some material effect on the tax liability, the same should be invariably reported.
- (iv) **Evaluation of internal control etc. :** Before determining the extent of audit checks to be applied i.e. whether to go in- depth or to do only test check, the auditor should ascertain whether there is an internal check system in operation in the entity. He should particularly find out how the purchases and sales gets initiated. For example, in case of purchase, receipt of indent by the purchase department, determining the need for purchases, initiation of purchase order, receipt of material, preparation of MRN, entries made in the books of accounts etc. should be verified. For sales, receipt of inquiry, acceptance of sales order, execution of sales, preparation of sale invoice and realization of transaction. If the internal control is reliable, the extent of audit may be reduced and should be focused only on those areas where the auditor feels that greater degree of audit risk is involved.
- (v) **Knowledge about the VAT law and allied laws :** The auditor and his staff should obtain a thorough knowledge of the State VAT law under which the audit is to be conducted. The auditor should study the VAT law starting from the definition of various terms, the procedure to be adopted, the provisions regarding issue of invoices, claiming of input tax credit, composition schedule in the VAT law, the manner in which the output tax is to be calculated the provisions of audit, the contents of the audit report, the periodicity of the return to be filed, the format of the forms of returns, and the various notifications issued. Further the auditor should know the Central Sales-tax law as he has to comment on the liability under that law

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also. The auditor should also have some knowledge about the judicial pronouncements made by the Tribunals and the Courts on the various facets of these laws.

(d) Focus of a Peer review

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 Review shall focus on:

- (i) Compliance with technical standards.
- (ii) Quality of reporting.
- (iii) Office systems and procedures with regard to compliance of attestation services systems and procedures.
- (iv) Training Programs for staff (including Articled and Audit Assistants) concerned with attestation functions, including appropriate infrastructure.

