

PAPER – 3 : ADVANCED AUDITING

Question No.1 is compulsory.

Attempt any **five** questions from the remaining six questions.

Question 1

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

- (a) Mr. Honest, Director of Truth private Ltd., is also a director of another company – False Private Ltd., which has not filed annual returns and accounts for the last three years, 2006-07; 2007-08 and 2008-09 with the Registrar of Companies. Truth Private Ltd., passed the following resolution reappointing Mr. Honest as Director of the company at the Annual General Meeting held on 31-08-10. (5 Marks)
- (b) 'A' Ltd. has not made any provision in its accounts as regards losses sustained by its subsidiary 'B' Ltd. However, it has credited to the Profit & Loss Account the dividend declared by its subsidiary 'C' Ltd., on its investments made in the subsidiary. (5 Marks)
- (c) XYZ Ltd. purchased an equipment at a price of \$ 1,00,000 on 2-4-09. Upon terms of credit that price should be settled within six months from the date of purchase. The company capitalized the asset in terms of Indian Rupees at a rate of exchange prevailing as on date of purchase. When the liability is settled as per terms on 10-09-2009, it incurs an additional amount of ` 3,50,000/- due to exchange rate fluctuation on the date of settlement. The said sum is charged off to Profit & Loss Account. (5 Marks)
- (d) LMN Ltd. has obtained term loan from Nationalised Bank amounting to ` 10 crores for purchase of Research and Development Equipments. Out of this, Company has utilised ` 10 lakhs towards purchase of office furniture and car to be used by the Chief Executive Officer of the company. (5 Marks)

Answer

(a) Disqualification of Director

The auditor of a company has to report under section 227(3) (f) of the Companies Act, 1956 that whether any director is disqualified from being appointed as a director under section 274(1) (g) of the Companies Act.

As per section 274(1)(g) of the Companies Act, 1956 a person who is already a director of a public company which has not filed the annual accounts and annual return for any continuous three financial years, shall not be capable of appointed as a director of the company.

The provisions of the Section 274(1) (g) of the Companies Act, 1956 are not applicable to a Private Ltd. Company. Since in the present case, both the concerned companies are Private Ltd. Company, Mr. Honest is not disqualified.

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(b) Disclosure of provision for loss of subsidiary companies

As per Clause 3(xiii) (XII) of Part II of Schedule VI of the Companies Act, 1956 Profit & Loss Account of a company shall disclose dividends from subsidiary companies and provisions for losses of subsidiary companies.

Schedule VI also deals with presentation of Income and Expenditure; Assets and Liabilities and does not deal with recognition and measurement of the Income and Expenditure or Assets and liabilities.

As per AS 13 "Accounting for Investment", in case of long term investments, provision for diminution shall be made to recognise a decline, other than temporary, in the value of investments.

In the instant case, while A Ltd has not made any provision in its accounts for losses sustained by its subsidiary B Ltd, it has credited the dividend declared by its subsidiary C Ltd on its investment made, to the profit and loss account. Thus, Company A Ltd. is justified in crediting the dividend declared by its subsidiary C Ltd to Profit and Loss Account. Similarly if the decline in the case of B Ltd is temporary, the action of A Ltd is in order. Otherwise, adjustments for the decline should be made in the accounts of A Ltd.

(c) Treatment of fluctuation of foreign exchange rates

As per AS 11 "The Effects of Changes in Foreign Exchange Rates", a foreign currency transaction should be recorded on initial recognition in the reporting currency, by applying to the foreign currency amount, the exchange rate between the reporting currency and the foreign currency at the date of the transaction.

Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at the rates different from those at which they were initially recorded during the period or reported in previous financial statements should be recognised as income or as expenses in the period in which they arise.

In the instant case XYZ Ltd. purchased equipment at a price of \$ 1, 00,000 on 2-4-09. The company has capitalised the asset in terms of Indian Rupees at the rate of exchange prevailing as on date of purchase. XYZ Ltd has charged the additional amount of ₹ 3, 50,000 due to exchange rate fluctuation (on the date of settlement) to profit and loss account.

In view of the above provisions charging of exchange rate fluctuation on the date of settlement to the profit and loss account of the XYZ Ltd is correct.

Alternatively

As per notification issued by Central Government in respect of accounting periods commencing on or after 7th December, 2006 and ending on or before 31st March, 2011, at the option of the enterprise, exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, insofar as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be

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accumulated in a “Foreign Currency Monetary Item Translation Difference Account” in the enterprise’s financial statements and amortized over the balance period of such long-term asset/liability but not beyond 31st March, 2011.

Hence in view of the above notification, if the Company has exercised its options as per notification, charging of exchange rate fluctuation on the date of settlement to the profit and loss account of the XYZ Ltd is not correct. The auditor should qualify the report.

(d) **CARO Requirement**

As per Paragraph 4 (xvi) of CARO, 2003, an auditor is required to comment whether the term loans were applied for the purpose for which the loans were obtained.

The auditor should examine terms and conditions of the term loan with the actual utilisation of the loans. If he finds that loan has not been used for the purpose for which they were obtained. The report should state the facts.

In the instant case, LMN Ltd. has taken term loan from a nationalized bank amounting to ` 10 crores for the purchase of research and development equipments. Out of this amount, company has utilised ` 10 lakhs for purchase of office furniture and car, to be used by the Chief Executive Officer of the company. The furniture and car cannot be considered research and development equipments.

Accordingly, the auditor should state the facts in his report that out of the term loan for research and development equipment, ` 10 lakhs utilised by the purchase of furniture and car is not for the purpose for which the term loan was obtained.

Question 2

Comment on the following with reference to the Chartered Accountants’ Act, 1949 and schedules thereto:

- (a) *Mr. Moon is the auditor of M/s Sun Ltd., which has a turnover of ` 100 crores. The audit fee for the year is fixed at ` 25 lakhs. During the year the company offers Mr. Moon an assignment of Management Consultancy for a remuneration of ` 50 lakhs. (4 Marks)*
- (b) *A firm of Chartered Accountants RJ & Co. was appointed by a company to evaluate the cost of products manufactured by it for its information system. One of the partners of the firm RJ & Co., was a non-executive Director of the Company. (4 Marks)*
- (c) *Mr. A, Chartered Accountant in practice as a Sole Proprietor has an office near Egmore. Due to increase in professional work, he opens another office in Tambaram which is approximately 30 kms away from his existing office. For running the new office, he has employed a retired Income Tax Officer. (4 Marks)*
- (d) *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 with International firm and also his achievements and recognition as an expert in the field of Taxation. The bio-data was read out during the said interview. (4 Marks)*

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Answer

(a) Restriction on Statutory Auditor

The Council Guidelines (2008) of ICAI specifies that a member of the Institute of Chartered Accountants in India, in practice, shall be deemed to be guilty of professional misconduct, if he accepts the appointment as a statutory auditor of a company having a turnover of ` 50 crores or more in a year and accepts any other assignment in regard to same company on a remuneration which in total exceeds the fee payable for carrying out statutory audit of the same company.

In view of the above, it would be misconduct on the part of Mr. Moon to accept the assignment of Management Consultancy for a fee of ` 50 lakhs.

(b) Misconduct of Chartered Accountant

The Council of the Institute of Chartered Accountants of India has categorically stated that in case 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 to the Chartered Accountants Act, 1949 states that expressing an opinion on financial statement of any business establishment in which the auditor, his firm or a partner of his firm has a substantial interest would constitute misconduct unless he discloses the interest in his report. In case, where a member of the Institute is a director of a company or a firm in which said member is a partner should not express any opinion on its financial statements.

In this case, firm RJ & Co. has been retained only to evaluate the cost of products manufactured by it for information system, which does not involve expression of opinion on financial statements. Therefore, RJ & Co. can accept the assignment.

(c) Branch Office

In terms of Section 27 of the Chartered Accountant 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 within a distance of 50 kms from the municipal limits of the first office's location.

In this case, since the second office is situated within 50 kms, Mr. A would not be considered as having committed professional misconduct.

(d) Prohibition on solicitation of work

Clause 6 of Part I of First Schedule to the Chartered Accountant Act, 1949 prohibits solicitation of work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means, would constitute professional misconduct.

The bio-data of the Member handed over during the interview was read out which contained personal recognition and achievements of the partner as an expert in the field of

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taxation. Such an act would lead to the promotion of his name and publicity thereof to the firm.

Hence it would tantamount to professional misconduct on the part of the partner under Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949.

Question 3

- (a) *The auditors need not review accounting policies unless there is a change in the basis of accounting – Comment.* (8 Marks)
- (b) (i) *'A' Ltd. having fixed assets at 10 different locations, in total valuing ` 5,000 crores, have been physically verifying the assets every third year. Auditor insists for yearly verification of the same – Comment.* (4 Marks)
- (ii) *'B' Ltd. manufacturing cycles has 150 employees. Auditors observe that it has not registered itself for Provident Fund and ESI purposes, not remitting the dues in time and auditor insists for qualifying the Report. Management contends that in the absence of registration it can't be construed that the company is in default of statutory dues on regular basis – Comment.* (4 Marks)

Answer

(a) Need to review accounting policies

The auditor while conducting the audit should critically examine the accounting policies adopted by the company and test them for conformity with the accounting standards and recommendations of the Institute. The Companies Act, 1956, as well as many other statutes, requires that the financial statements of the company 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 as under:

"While discharging the attest function, it is 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, it is the duty of the members 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.

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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 accounting policies followed vary from company to company. Disclosure of accounting policies followed is necessary, if the financial statement has to be understood and appreciated. There is no single list of accounting policies are applicable to all circumstances.

The choice of appropriate accounting policies, principles and methods of applying those principles in the specific circumstances of each enterprise depends on the management decision.

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.

Therefore, the auditor should determine himself as to whether or not the said treatment is consistent with the basic principles of accounting. Thus, 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.

(b) (i) Physical Verification of Fixed Assets

As per CARO, 2003, an auditor is required to report following particulars relating to Fixed Assets under CARO

- (a) Whether the company is maintaining proper records showing full particulars, including quantitative details and situation of Fixed Assets. [Paragraph 4(i)(a)]
- (b) Whether these Fixed Assets have been physically verified by the management at reasonable intervals: whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of accounts [paragraph 4(i)(b)]
- (c) If a substantial part of Fixed Assets have been disposed off during the year, whether it has affected the going concern [Paragraph 4(i)(c)]

What constitutes "reasonable intervals" depends upon the circumstances of each case. The factors to be taken into consideration in this regard include the number of assets, the nature of assets, the relative value of assets, difficulty in verification, situation and spread of the assets, etc. The management may decide about the periodicity of physical verification of fixed assets considering the above factors. While an annual verification may be reasonable, it may be impracticable to carry out the same in some cases. Even in such cases, the verification programme should be such that all assets are verified at least once in every three years. Where verification of all assets is not made during the year, it will be necessary for the

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auditor to report that fact, but if he is satisfied regarding the frequency of verification he should also make a suitable comment to that effect.

In the instant case, A Ltd., having fixed assets at 10 different locations, in total valuing ₹ 5000 crores is physically verifying the assets every third year. As per CARO, 2003, verification of fixed assets should be done on reasonable intervals, and reasonable intervals may be, in some cases that all assets are verified at least once in every three years. Hence if the auditor is satisfied with the frequency, it is not necessary for A Ltd. to verify the fixed assets on an annual basis. However, a suitable comment to the effect has to be made by the auditor in his report.

(ii) **Non-remittance of PF & ESI dues**

As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statements", Non-compliance by the entity with laws and regulations may result in a material misstatement of the financial statements. Detection of non-compliance, regardless of materiality, may affect other aspects of the audit.

If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements.

In the instant case, B Ltd. manufacturing cycles has 150 employees. It has been observed that it is not registered for Provident Fund and ESI Authorities which is prima facie ground to qualify the report. On the other hand, B Ltd. is also not remitting the dues in time. As per CARO, 2003 issued under section 227(4A) of the Companies Act, 1956, the auditor is required to report whether the company is regular in depositing Provident Fund or Employees' State Insurance (ESI) dues with the appropriate authority.

The reason put forward by the Management that in the absence of registration it can't be construed that the company is at default of remittance of statutory dues on regular basis is no excuse for not remitting dues in time. Thus, the auditor has to qualify the report.

Question 4

- (a) *The Company ABC Ltd. has passed a Special Resolution at the Annual General Meeting held on 30-09-09 for buy back of shares to the extent of ₹ 12, 50,000.*

Summary of Financial Position of ABC Ltd. as on 31-03-09

Subscribed & Paid up		Fixed Assets	40,00,000
Share Capital	25,00,000		
Reserves and Surplus	20,00,000	Current Assets	12,00,000
Current Liabilities	<u>15,00,000</u>	Loans & Advances	<u>8,00,000</u>
	<u>60,00,000</u>		<u>60,00,000</u>
Comment whether the action of the Company is valid.			(8 Marks)

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- (b) PQR Private Ltd. has prepared the financial statements for the year ended 31-03-10 and submitted the same to you for audit. Comment whether sundry debtors and loans and advances have been disclosed as required under Schedule VI of the Companies' Act, 1956.

Balance Sheet of PQR Private Ltd. as on 31-03-10

Liabilities		Assets	
<i>Share Capital</i>		<i>Fixed Assets</i>	
Authorised 1,00,000 Equity Shares of ` 10/- each	<u>10,00,000</u>	Gross Block	
Subscribed & Paid up 1,00,000 Equity Shares of ` 10/- each	10,00,000	Less: Depreciation	25,00,000
Reserves & surplus		<i>Current Assets</i>	
Profit & Loss A/c	1,50,000	Cash & Bank	2,00,000
Secured Loans		Sundry Debtors	7,00,000
Indian Bank		Loans & Advances	2,50,000
(against hypothecation of Fixed Assets)	20,00,000		
Current Liabilities & Provisions	5,00,000		
Creditors for Trade			
	<u>36,50,000</u>		<u>36,50,000</u>

(8 Marks)

Answer

(a) Buy-back of shares

The provisions regulating buy back of shares are contained in Section 77A, 77AA and 77B of the Companies Act, 1956.

The auditor should ensure the compliance of all the provisions relating to buy-back and also see that proper accounting entries have been passed. Audit procedure to be followed may be as under:

- (i) Ensure that the buy-back has been done only out of the company's free reserves or its securities premium account or out of the proceeds of any shares or other specified securities other than out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

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- (ii) Check authorisation in the Articles of Association which is a pre-requisite of any buyback.
- (iii) Examine special resolution passed in the general meeting authorising buyback.
- (iv) Ascertain that quantum of buy-back is either equal to or less than 25% of the total paid up share capital and free reserves but in the case of buy-back of equity shares in any financial year it should not exceed 25% of its total paid-up equity capital in that financial year.
- (v) Check that the debt equity ratio should not be more than 2 : 1 except in cases where Central Government allows higher ratio for a class or classes of companies.
- (vi) Ensure that shares or other specified securities to be bought back should be fully paid-up.

In the instant case, the action of the company is not valid. The company at the most is eligible to buyback 25% of paid up capital and free reserves i.e. 25% on ` 45,00,000 which would amount to ` 11,25,000 only. Hence, passing of Special Resolution at the Annual General Meeting for buy back of shares to the extent of ` 12, 50,000 is invalid.

- (b) As per the Schedule VI of the Companies' Act, 1956, sundry debtors and loans and advances should be classified into:

A. Sundry Debtors:

1. Classification by Age

- (a) Debtors outstanding for a period exceeding 6 months and
- (b) other debts.

The amount of provision for doubtful debts shall be shown separately. This is called classification by Age.

2. Classification by nature:

- (a) Debts considered good and in respect of which the company is fully secured.
- (b) Debts considered good for which the company holds no security other than the debtor's personal security and
- (c) Debts considered doubtful or bad.

3. Classification by party:

- (a) Debts due by the Directors or other officers of the company, or any of them severally or jointly with any other person. (The term "officer" includes any Director, Manager, or secretary but not auditor).
- (b) Debts due by Firms or private companies respectively in which any director is a partner or a director or a member, as the case may be.

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- (c) Debts due from other companies under the same management alongwith names of companies concerned.

The maximum amount due by directors or other officers of the company at any time during the year to be shown by way of a note.

4. **Provisions:** Provisions shown herein should not ensure the amount of the debts considered doubtful or bad-surplus provided, if any shall be shown as a revenue under the head "reserves and surplus" under the heading "Reserve for Doubtful or bad debts".
- 5 **Excluded items:** The amounts to be shown under sundry debtors shall include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations, but shall not include the amounts which are in the nature of loans or advances.

B. Loans & Advances

1. (a) Advances and loans to subsidiaries
(b) Advances and loans to partnership firms in which a company or any of its subsidiaries is a partner
2. Bills of exchange
3. Advances recoverable in cash or kind or for value to be received
4. Balances with customs, Port Trust etc.

Conclusion:

In the instant case, PQR Pvt. Ltd has not classified Sundry Debtors and Loans & Advances as per Schedule VI of the Companies Act.

Question 5

- (a) (i) *For determining the liability for Gratuity, Actuary's Report is produced to the auditor. On examination auditor notices a serious wrong assumption in the report. Auditor challenges the Actuary's report – Comment. (4 Marks)*
- (ii) *The loss as per Profit and Loss Account of a Ltd. Company is converted in to profits due to crediting of time barred liability relating to the purchase of Plant & Machinery. Directors propose to declare dividend out of such profits – Comment. (4 Marks)*
- (b) *You have been approached by an organization to suggest a system where the user wants to access data immediately. What would be your suggestions if they want to process it after validation? (8 Marks)*

Answer

- (a) (i) **Using the work of an Expert :**

SA-620 "Using the Work of an Expert" deals with evaluating the work of an expert. As per Standards on Auditing 620, the auditor does not have the same expertise

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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. The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. the auditor definitely has a right to challenge the Actuary's report. It is required that the auditor seeks reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial information by among things considering the assumptions and methods used.

Accordingly, the auditor has to satisfy himself whether valuation done by the actuary can be adopted, otherwise he may report on the wrong assumption. In the present case, the auditor has come across a wrong assumption made by the Actuary. Hence he should express his opinion accordingly in accordance with Para 14 of SA 620.

- (ii) **Payment of dividend:** Profit arising due to crediting a time-barred liability of this nature is a capital profit. It will be available for distribution as dividend only if the following three conditions are fulfilled.

As per Guidance Note on 'Audit of Payment of Dividend', capital profits can be distributed as dividend only if all the following conditions are fulfilled:

- (i) the Articles or the bye-laws or other rules and regulations applicable to the entity, permit such distribution; and
- (ii) it has been realised in cash; and
- (iii) the Board or similar authority is satisfied that net aggregate value of the assets remaining after distribution of that profit will not be less than the book values so that share capital and reserves remaining after the distribution will be fully represented by the remaining assets.

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.

In the instant case, the company has converted the loss into profits by crediting the time bound liability relating to purchase of fixed assets. Profit arising due to crediting a time-barred liability of this nature is a capital profit which is not realised in cash. Hence, declaration of the dividend out of such profits is not valid. The auditor should qualify the report.

- (b) **On-line real time systems:** The on-line real time system enables the users to access data and programmes directly through terminal devices. When an organisation uses an on-line system, the technology is likely to be complex and it is linked with strategic business plan. The individual transactions are entered at terminal devices, validated and used to update related computer files immediately.

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Transactions are entered as they occur, and are processed on entered. This system forms the heart of management information system. 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.

However, if the user wants to process the data after validation then the on-line/batch processing system may be used.

Batch processing system: In on-line batch processing system, individual transactions are entered at a terminal device subject to certain validation checks and added to a transaction file that contains other transactions entered during the period. The transaction file may be validated further during every processing cycle and relevant master file is updated. Transactions are accumulated and grouped for the day and processed as a group. They do not process transaction as quickly as more advanced online system does.

The auditor may offer his suggestion on both cases after taking the requirement of the organization into consideration and based on cost benefit analysis.

Question 6

- (a) (i) ARG Bank has granted loans to the extent of ₹ 1500 crores. 10 parties have not been repaying the principal amount and servicing the interest for more than 36 months. During the year ended 31-3-10, it was found that two of the ten parties have paid interest partly and bank has accounted full amount of interest accrued as income in respect of two parties – Comment. (4 Marks)
- (ii) ARG Bank has paid money on the drafts issued by other branches. But later on it was found that this amount is shown under suspense account – Comment. (4 Marks)
- (b) AB & Co., Chartered Accountants, was appointed to compile financial statements of Y & Co., a firm for Tax Audit purposes. During the course of work, the audit firm has noticed that the stock valuation was grossly understated. When it was pointed out, the management told that AB & Co. are not the statutory auditors of the company and need not be concerned about valuation of stock – Comment. (8 Marks)

Answer 6

(a) (i) Income Recognition

Reserve Bank of India has issued guidelines to be followed by all scheduled commercial banks – for income recognition, asset classification, provisioning and other related matters. In case of Non Performing Assets (NPA) accounts, income should be recognised only on realisation irrespective of the system of accounting followed. The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed/derecognised or not recognised in the past should be accounted. Interest partly realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

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In the instant case, where two of the ten parties have paid part interest only whereas bank has accounted full amount of interest accrued as income in respect of two parties. Hence, the auditor should indicate the same in his report.

(ii) 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 has to be verified with particular reference to any long outstanding items. The auditor should further 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 seek confirmation of transactions relating to such outstanding cases. The auditor should also pay special attention to unusual items in suspense account. He should obtain details for the delay in adjusting the entries and if it requires provisions or write-off he has to ensure that the same has been made.

(b) **Engagements to Compile Financial Information for Tax Audit Purpose**

As per 'SRS 4410 "Engagements to Compile Financial Information", if the accountant becomes aware of material misstatements, the accountant should persuade the management to carry out necessary amendments in the financial statements or other compiled financial information. If such amendments are not made and the financial statements are still considered to be misleading, the accountant should withdraw from the engagement.

As per guidance note on Tax Audit under section 44AB of the Income Tax Act, 1961, the tax auditor should study the procedure followed by the assessee in taking the inventory of closing stock at the end of the year and the valuation thereof. The tax auditor should also examine the basis adopted for ascertaining the cost and ensure that this basis is consistently followed. It is very necessary for an auditor to ensure that the method followed for valuation of stock results in disclosure of correct profit and gains.

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In the instant case, AB & Co, Chartered Accountants was appointed to compile financial statements for tax audit purpose of Y & Co, a firm. It is the duty of AB & Co, to ensure that the method followed for valuation of stock results in disclosure of correct profit and gains.

In this case, the stock valuation was grossly understated. Consequently, the disclosure of profit is also not correct. Hence the contention of the management of Y & Co, that AB & Co are not the statutory auditors, so they need not be concerned about valuation of stock is not correct. Hence, the auditor may withdraw from the engagement if the management insists on their stand.

Question 7

Write short note on any four of the following:

- (a) *Other Misconduct*
- (b) *Rolling Statement*
- (c) *Corporate Governance*
- (d) *Inquiry*
- (e) *Reconciliation of cost and financial records.*

(4 × 4 = 16 Marks)

Answer

(a) Other Misconduct:

1. A member is liable to disciplinary action under Section 21 of the Chartered Accountant Act if he is found guilty of any professional or 'other misconduct'
2. Other misconduct has been defined in Part IV of First Schedule and Part III of Second Schedule in the CA (Amendment Act) 2006
3. As per Part IV of First Schedule of the CA Act, a member of the Institute whether in practice or not, shall be deemed to be guilty of other misconduct if he
 - (i) Is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months
 - (ii) 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
4. As per Part III of Second Schedule to the CA Act, a member of the Institute whether in practice or not shall be deemed to be guilty of other misconduct if he is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term exceeding six months.

This provision empowers the Council to enquire any misconduct of a member even if it does not arise of professional misconduct.

(b) Rolling Statement:

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"

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business days from the transaction date. If a transaction is entered on Monday on T + 2 Rolling Statement, it will be settled on Wednesday when pay in or payout take place.

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 mandated most of the scrips to be settled exclusively on rolling settlement basis. 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.

(c) Corporate Governance:

Corporate Governance is the system by which the management of a business entity directs and controls the activities in the best interest of the stakeholders. It is about the commitment to values, ethical business conduct and about making a distinction between personal and corporate funds in the management of a company. Clause 49 of the Listing Agreement covers SEBI guidelines regarding corporate governance. It deals with Board's directors including compositions and compensation, provision regarding board's committee, functioning of audit committee, management of subsidiary companies, disclosure of important issues such as related party transactions, accounting policies, principle of risk management, accounting for proceeds from public/right/preferential issues, content of management discussion and analysis, CEO/CFO certification, report of corporate governance and compliance certificate.

(d) Inquiry

"SA 500 Audit Evidence" mentions inquiry as one of the methods of collecting evidence by seeking appropriate information from knowledgeable persons, both financial and non-financial, within the entity 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 possess earlier or may not provide him with corroborative evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

The need for inquiry may arise at every stage of auditing. Evaluating responses to inquiries is an integral part of the inquiry process.

Auditor has to make a statement in his report whether he has obtained all information and explanation that he considered necessary for audit. This is possible through inquiry, as one of the methods of obtaining information.

(e) Reconciliation of Cost and Financial Records:

The cost records should be reconciled (preferably periodically with the financial books of account so as to ensure accuracy.) Variations, if any, should be clearly indicated and explained. The period for which such reconciliation be effected should not exceed the period of the financial year of the company.

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The reconciliation should be done in such a manner that profitability of the product under reference can be correctly adjudged and reconciled with the overall profits of the company. A statement showing the total expenses incurred by the company, including expenses excluded from the costing records and expenses on products not covered by the relevant Cost Accounting Records Rules, should be prepared and the share of the product covered by the Rules in such expenses should be indicated. Also the sale realisation of the products should be shown separately for products covered by the Rules and products not so covered and the margin representing the difference between respective sales realisation and the corresponding total cost should be determined. This statement in turn should be reconciled with the financial profit and loss account for the period. It may be mentioned that where a system of integrated cost and financial accounting is in operation, this reconciliation will be facilitated to a large extent. In this connection it may be noted that Schedule VI to the Companies Act requires the companies to give considerable amount of information regarding licensed capacity, installed capacity, actual production, consumption of raw material, etc. It should be ensured that the specific information required to be contained in both the costing and financial statements is not different. If at all any difference arises, the same should be properly reconciled and kept on record for reference.

