CA-FINAL

ADVANCED AUDITING & PROFESSIONAL ETHICS

INTRODUCTION

THIS ARE THE SAMPLE QUESTIONS & ANSWERS BASED ON THE PAPER "ADVANCED AUDITING & PROFESSIONAL ETHICS" IN CA FINAL EXAMINATION. BESIDES AUDITING, THIS PAPER REQUIRES EXPERT KNOWLEDGE OVER THE FOLLOWINGS:

1. **CHARTERED ACCOUNTANTS ACT, 1949**
2. **COMPANIES ACT, 1956.**
3. **STANDARDS ON AUDITING.**
4. **ACCOUNTING STANDARDS.**
5. **CARO 2003 (2005 EDITION)**
6. **STATEMENT ON REPORTING U/S 227(1A) OF THE COMPANIES ACT, 1956.**
7. **GUIDANCE NOTES.**
8. **COMPUTER ADDED AUDIT TECHNIQUES (CAAT).**
9. **GUIDANCE NOTES ON AUDIT U/S 44AB OF THE INCOME TAX ACT, 1961.**
10. **INTERNAL AUDIT TECHNIQUES.**
11. **INCOME TAX ACT, 1961.**

SO, BEFORE STARTING STRICTLY FOLLOW UP THE ABOVE ISSUES AND THEN READ THE QUESTIONS & ANSWERS GIVEN BELOW. YOU CAN AT LEAST GET AN OVERALL IDEA ABOUT THE STANDARD OF THIS PAPER.

HAPPY READING……………………......……………HAPPY READING

IMPORTANT QUESTIONS & ANSWERS ON ADVANCED AUDITING & PROFESSIONAL ETHICS.

1. *As a practising chartered accountant do you approve the following? If not, why?*

(a) *In a representation to be submitted to a company under section 225(3) of the Companies Act, 1956, the partner of the firm of auditors wants to include the contributions made by the firm in strengthening the control procedures of the company during their association with the company.*

(b) *A partner of a firm of chartered accountants during a T.V. interview handed over a bio-data of his firm to the chairperson. Such bio-data detailed the standing of the international firm with which the firm was associated. It also detailed the achievements of the concerned partner and his recognition as an expert in the field of taxation in the country. The chairperson read out the said bio-data during the interview.*

(c) *The Chairman of an Audit Committee of a Blue chip Company, who is a chartered accountant asked the firm in which he was previously a partner to quote their fee on a success fee basis so as to ensure that a professional work is assigned to such firm.*

(d) *A firm of chartered accountants was appointed by a company to evaluate the costs of the various products manufactured by it for their information system. One of the partners of the firm of chartered accountants was a non-executive director of the company.*

ANSWER

(a) Section 225(3) of the Companies Act, 1956 permits a retiring auditor to make a representation in writing (not exceeding a reasonable length) to the company. The proposition of the partner to highlight contributions made by the firm in strengthening the control procedures in the representation is not acceptable because the representation letter should not be prepared in a manner so as to seek publicity. The Code of Ethics issued by the Institute makes it amply clear that the right to make representation does not mean that an auditor has any prescriptive right or a lien on an audit. The wording of his representation should be such that, apart from the opportunity not being abused to secure needless publicity, it does not tantamount directly or indirectly to canvassing or soliciting for his continuance as an auditor. The letter should merely set out in a dignified manner how he has been acting independently and conscientiously through the term of office and may, in addition, indicate if he so chooses his willingness to continue as auditor if reappointed by the shareholders. Thus, such action proposed by a partner could not be approved since, it would lead to his being held guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(b) Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits solicitation of client or professional work either directly or indirectly by circular, advertisement personal communication or interview or by any other means since it shall constitute professional misconduct. The bio-data was handed over to the chairperson during the T.V. interview by the Chartered Accountant which included details about the firm and the achievements of the partner as an expert in the field of taxation. The chairperson simply read out the same in detail about association with the international firm as also the achievements of the partner and his recognition as an expert in the field of taxation. Such an act would definitely lead to the promotion of the firms' name and publicity thereof as well as of the partner and as such the handing over of bio-data cannot be approved. The partner would be held guilty of professional miscount under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(c) Professional services cannot and should not be offered under an agreement which entails that fees shall be payable on a success fee basis. The fees payable, therefore, become contingent in nature. It is obvious that a person who is to receive payment in direct proportion to the benefit received by his client, may be tempted to exaggerate the advantage of his service or may adopt means which are not ethical. It will have the effect of undermining his integrity and impairing his independence.

Therefore, the remuneration based on a percentage of the profits or on the happening of a particular contingency such as, the successful outcome of an appeal in revenue proceedings is prohibited. Therefore, the action of the firm to quote fees in such a manner on the advice of the Chairman of the Audit Committee to ensure their appointment could not be accorded approval and the member would be held guilty of professional misconduct under Clause (10) of Part I of the Chartered Accountants Act, 1949. In the instant case, the Chairman of Audit Committee who also happens to be a chartered accountant would also be guilty of misconduct under the Chartered Accountants Act, 1949.

(d) The Council of the Institute of Chartered Accountants of India has categorically stated that in cases where a member is a Director of a company, the firm in which the said member is a partner, should not express any opinion on its financial statements. Clause 4 of Part I of the Second Schedule desists a chartered accountant to express opinion on financial statements of an enterprise in which he, his firm or a partner in his firm has a substantial interest unless he discloses the interest in his report. Since the firm has been appointed to evaluate the costs of the various products manufactured by it for their information system, it cannot be construed to be misconduct under Clause (4) Part I of the Second Schedule to Chartered Accountants Act, 1949.

2. (a) *PQ & Co., a firm of chartered accountant having 2 partners P and Q , one in charge of head office and another in charge of Branch at a distance of 50 kms.., puts a name board of the firm in both premises and also in their respective residences. Comment.*

(b) (i) *A chartered accountant has been offered a job in Mi ST & Company by an agent B. Chartered accountant agrees to pay to B, 10% of the emoluments he would receive during the period of his job. Is he guilty of professional misconduct?*

(ii) *A chartered accountant has been offered a job in MiS ST & Company by an agent. He promises to his wife that he would share 50% of his earning during the tenure of this job. Is he guilty of professional misconduct?*

(c)*X. a chartered accountant in practice has been a member of the institute for 2 years. He starts using the letter FCA on his visiting card. Is he deemed to be guilty of professional misconduct?*

(d)*The Institute of Chartered Accountants of India asks 'Y' a chartered accountant to confirm the date of leaving the services by the paid assistant .In spite of repeated reminders he failed to reply to the letters of the Institute. Comment.*

<u>ANSWER</u>

(a) The council of the Institute has decided that with regard to the use of the name-board, there will be no bar to the putting up of a name-board in the place of residence of a member with the designation of chartered accountant, provided, it is a name-plate or board of an individual member and not of the firm. In the given case partners of X Y & Co., put up a name board of the firm in both offices and also in their respective residences. Thus the chartered accountants are guilty of misconduct. Distance given in the question is not relevant for deciding.

(b) As per clause (1) of Part II of The First Schedule to the Chartered Accountants Act, 1949, A member of the Institute (other than a member in practice) shall be deemed to be guilty of professional misconduct, if he being an employee of any company, firm or person pays or allows or agrees to pay directly or indirectly to any person any share in the emoluments of the employment undertaken by him.

A member of the Institute in service is deemed to be guilty of professional misconduct, if he is an employee of any company, firm or person and during that course whatever emoluments he receives, if he either pays or allows to pay or agree to pay any part or share thereof whether directly or indirectly. However, this clause dose not restricts such sharing or commitments among relatives, dependents, friends etc., if there is no relationship in procuring or retaining the job and payment is not a consideration for job procurement or retainership. The clear verdict of this clause is that job must be procured and retained with own professional capabilities and not by any financial deal impairing professional dignity.

(i) In this case chartered accountant is guilty of professional misconduct.

(ii) In this case chartered accountant is not guilty of professional misconduct.

(c) As per Clause (1) of PART III of the First Schedule to the Chartered Accountants Act, 1949, A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he not being a fellow of the Institute, acts as a fellow of the Institute. Every member of the Institute whether in practice or not, shall be deemed to be guilty of professional misconduct, if he is associate member (ACA) of the Institute, acts (including such disclosure of exhibition by way of letter, visiting card etc.) as fellow member (FCA) of the institute. Therefore X will be deemed to be guilty of professional misconduct.

(d) As per Clause (2) of PART III of the First Schedule to the Chartered Accountants Act, 1949, A member of the Institute, whether in practice or not, shall 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 Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority. Thus Y is guilty of professional misconduct under this clause.

3. *Answer the following:*

(a) *List the special features involved in the audit of a Cooperative Society.*

(b) *Draft an Audit program for conducting the audit of a Public Trust registered under section 12A of the Income Tax Act, 1961*

ANSWER

(a) Following are the special features in the audit of a cooperative society:

- Examination of overdue debts.
- Special treatment of over due interest in the determination of profit.
- Certification of bad debts before write off.
- Valuation of assets and liabilities
- Adherence to co-operative Principles.
- Observations of the Provisions of the Act and Rules
- Verification of members' Register and examination of their pass books
- Special report to the registrar on fraud, mismanagement and personal profiteering.
- Audit classification of society based on the audit findings
- Discussion of draft audit report with the managing committee.

(b) An auditor should conduct routine checking during the course of audit of a public trust, in the following manner:

(i) Check the books of account and other records having regard to the system of accounting and internal control

(ii) Vouch the transactions of the trust to satisfy that:

1. the transaction falls within the ambit of the trust
2. the transaction is properly authorized by the trustees or other delegated authority as may be permissible in law;
3. all incomes due to the trust have been properly accounted for on the basis of the system of accounting followed by the trust;
4. all expenses and outgoings appertaining to the trust have been recorded on the basis of the system of accounting followed by the trust;
5. amounts shown as applied towards the object of the trust are covered by the objects of trust as specified in the document governing the trust.

(iii) Obtain trial balance on the closing date certified by the trustees' duty certified by the trustee;

(iv) Obtain Balance Sheet and Profit & Loss Account of the trust authenticated by the trustees and check the same with the trial balance with which they should agree.

***4.** Answer the following:*

***(a)** Enumerate the verification procedures in relation to audit of a Hire-Purchase Finance Company.*

***(b)** As the tax auditor of a non-corporate entity u/s 44AB of the Income Tax Act, 1961, how would you ensure compliance of section 145 of the Income Tax Act, 1961?*

<u>ANSWER</u>

(a) ***<u>Verification Procedures in relation to audit of a Hire Purchase Finance company (HPFC):</u>***

Hire Purchase Finance Company

1. Ascertain whether the NBFC has an adequate appraisal system for extending hire purchase finance. The system of appraisal is basically concerned with obtaining information regarding the credit worthiness of the hirer, his experience in the field, assets owned, his past track record and future projections of his income.
2. Verify that the payment for acquiring an asset should be made directly to the supplier/dealer and that the original invoice has been drawn out in the name of the NBFC.
3. In the case of high value hire purchase items relating to machinery/equipment, an auditor should ascertain whether the valuation reports and installation reports are called for. In case of some high value items, he should also physically verify the asset in possession of the hirers, particularly in a situation where he has any doubts as regards the genuineness of the transaction.
4. If the hire purchase finance is against vehicles, check whether the registration certificate contains an endorsement in favour of the hire purchase company.
5. The auditor should verify whether the NBFC has a system in place for verifying the hire purchase assets periodically to ensure that the hirers have not sold the assets or otherwise encumbered them.
6. Check whether hire purchase instalments are being received regularly as and when they fall due. Check whether adequate provision has been made for overdue hire purchase instalments as required by the NBFC Prudential Norms directions.
7. Examine the method of accounting followed by the hire purchase finance company for appropriation of finance charges over the period of the hire purchase contract. Ascertain that there is no change in the method of accounting as compared to the immediately preceding previous year.
8. Verify that the assets given on hire purchase have been adequately insured against.
9. In case the goods are repossessed by the hire purchase finance company on account of non-repayment of hire purchase instalments, verify that the repossessed goods have been valued on a realistic basis by the hire purchase finance company.

(b) Income under the head Profit & Gains of business or profession or income from other sources has to be computed under mercantile or cash system of accounting as regularly maintained by the assessee.

The Central Government may notify in the official Gazette from time to time the accounting standards to be followed by any class or assesses or in respect of any class of income. The following Accounting Standards have been notified.

- AS (IT)-1: Disclosure of accounting policies.
- AS (IT)-2: Disclosure of prior period and extra ordinary items and disclosure of accounting policies.

The above AS are corresponding to AS-1 and AS-5 respectively if the ICAI u/s 145(3) the Assessing Officer may make a best judgement assessment under section 144 in the following assessment under section 144 in the following situation:

- Where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the assessee
- Where the method of accounting has not been regularly followed by the assessee.

- Where the AS notified u/s 145(2) have not been regularly followed by the assessee.

The auditor has to therefore ensure that:

(a) the entity follows either the cash or accrual method of accounting

(b) Accounting policies are required by AS (IT) -1 has been disclosed separately.

(c) Other provisions of AS 1 (IT) and AS (IT) -2 have been complied with.

5. *Answer the following:*

(a) *What are the points to be considered while evaluating the "Knowledge of the Business" in the conduct of an audit?*

(b) *Write short notes on:*

(i) *Probable format of Environmental Statement.*

(ii) *"Reporting" stage in Peer Review.*

ANSWER

(a) Points to be considered while evaluating "*Knowledge of the Business*" (as per erstwhile AAS 20 which has now been withdrawn):

(i) Changes in management, organization structure and activities of the client;

(ii) Legislation charges affecting the business of the client

(iii) Business developments affecting the client.

(iv) Existence of related parties with whom business is being conducted by the client

(v) Changes in technology, production facilities and its effect on profitability

(vi) Significant matters from earlier years audit reports etc.

(vii) Changes in internal control systems

(viii)New facilities and other charges made during the year

(ix) Relevance of work carried out by internal auditors.

(b) (i) Probable format of "Environmental Statement"

(a) Name/address of owner/occupier of the industry, operation or process.

(b) Date of last environmental audit report submitted

(c) Consumption of water and other raw materials as input during current and previous year.

(d) Pollution generated in air and water with output and types of pollutants and deviation from standard.

(e) Generation of hazardous waste in current year and previous year from processes or from pollution control facility.

(f) Quantity of sold waste generated during current year and previous year from process/es from pollution control facility and from recycling or reutilization of waste, etc.

(g) The disposal practice for different type waste.

(h) The practice of conservation of natural resources.

(ii) The additional investment proposal for environmental protection including abatement of pollution.

(iii) Reporting stage in Peer Review: This includes the following steps:

1. *Preliminary Report of Reviewer* - At the end of the on-site review, the reviewer is required to send a preliminary report to the practice unit before making any report to the Board on the areas in case systems and procedures of the practice unit reviewed have been found to be deficient or where noncompliance with reference to any other matter has been noticed by the reviewer during the course of review. The reviewer has to take care that the report does not contain name of any individual of the practice unit. However, no preliminary report is required in case no deficiencies or non- compliance are noticed by the reviewer. The reviewer while preparing the preliminary report should review and assess the conclusions drawn from the review that indicates the deficiencies to be reported upon. The preliminary report is addressed to the practice unit. The report, apart from mentioning the areas where systems and procedures of the practice unit have been found to be deficient, should also contain a paragraph that discusses the scope of

the review performed by the reviewer. If the reviewer draws a conclusion that there existed a limitation on scope of review, the fact, along with such limitation on the scope of the review, should also be communicated to the practice unit through the preliminary report. The reviewer should prepare the report on his letterhead. The report should be dated and also contain the reviewer's signature and membership number and reviewer's code number allotted by the Board.

2. *Reply to Preliminary Report* - The practice unit has to send its submissions or representations, in writing, to the reviewer, on the areas mentioned in the preliminary report. The reply to the preliminary report should be sent by the practice unit within a period of 21 days from the receipt of the preliminary report from the reviewer.

3. *Interim Report of the Reviewer* **-** If the reviewer is not satisfied with the reply of the practice unit, the reviewer has to submit an interim report to the Board. The report so submitted should clearly indicate that it is an "interim report". It may be noted that the Board may then give recommendations to the practice unit and instruct the reviewer to carry out a further review after minimum six months in case of any weakness in the compliance of technical standards is reported by the reviewer or follow up review after twelve months in case of any weakness in the internal control system of the concern is reported by the reviewer and to verify whether the systems and procedures of the practice unit have been modified appropriately. The reviewer is then required to submit a report to the Board.

4. *Final Report of the Reviewer* - If the reviewer is satisfied with the reply of the practice unit, the reviewer shall submit his final report to the Board. The final report should incorporate the findings as discussed with the practice unit.

6. (a) *The auditor must evaluate major clauses of control used in a Computerised Information system to enhance its reliability – Comment.*

(b) *You have been appointed as the auditor of a Multiplex Cinema House. Draw an audit program in respect of its Revenue and Expenditure.*

ANSWER

(a) The reliability of a component is a function of control that acts on the component. In a computer system the following are the major types of controls are used to enhance component reliability which the auditor must evaluate:

(1) *Authenticity Control*: They are exercised to verify the identity of the individuals or process involved in a system. (Pass word, digital signature etc.)

(2) *Accuracy Control*: These attempts to ensure the correctness of the data and processes in a system (Programme validation check).

(3) *Completeness Control*: This ensures that no data is missing and all processing is carried through to its proper conclusion.

(4) *Privacy Control*: This ensures the protection of data from inadvertent or unauthorised disclosure.

(5) *Audit Trail Controls*: This ensures the traceability of all events occurred in a system.

(6) *Redundancy Control*: It ensures that processing of data is done only once.

(7) *Existence Control*: It attempts to ensure the on going availability of all system resources.

(8) *Asset safeguarding controls*: It attempts to ensure that all resources within a system are protected from destruction or corruption.

(9) *Effectiveness Control*: It attempts to ensure that the system achieves its goals.

(10) *Efficiency Control*: It attempts to ensure that a system uses minimum resources to achieve its goals.

(b) ***Audit Program of Multiplex***

1. Peruse the Memorandum of Association and Articles of Association of the entity.
2. Ensure the object clause permits the entity to engage in this type of business.
3. In the case of income from sale of tickets:

- Verify the control system as to how it is ensured that the collections on sale of tickets of various shows are properly accounted.
- Verify the system of relating to on line booking of various shows and the system of realization of money.
- Check that there is overall system of reconciliation of collections with the number of seats available for different shows on a day.

4. Verify the internal control system and its effectiveness relating to the income from cafes shops, pubs etc., located within the multiplex.
5. Verify the system of control exercised relating to the income receivable from advertisements exhibited within the premises and inside the hall such as hoarding, banners, slides, short films etc.
6. Verify the system of collection from the parking areas in respect of the vehicles parked by the customers.
7. In the case of payment to the distributors verify the system of payment which may be either through out right payment or percentage of collection or a combination of both. Ensure at the time of settlement any payment of advance made to the distributor is also adjusted against the amount due.
8. Verify the system of payment of salaries and other benefits to the employees and ensure that statutory requirements are complied with.
9. Verify the payments effected in respect of the maintenance of the building and ensure the same is in order.

7. (a) *State the main features of the Qualified and Independent Audit Committee set up under clause 49 of the listing agreement.*

(b) *As Auditor of Act Fast Ltd. what steps will you take to ensure that the dividend has been paid only out of profit?*

ANSWER

(a) The main features of a qualified and independent audit committee to be set up under clause 49 of listing agreement are as follows:

- The audit committee shall have minimum three directors as members; Two-thirds of the members of the committee shall be independent directors.
- All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.
- The term, "*financially literate*", shall mean the ability to read and understand basic financial statements i.e., balance sheet, profit and loss account and statement of cash flows.
- A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting or professional certification in these areas.
- The Chairman of audit committee shall be an independent director.
- The Chairman of the committee shall be present at the annual general meeting to answer shareholder queries.
- The audit committee may invite executives, the finance director, head of internal audit and a representative of the statutory auditor.
- The Company Secretary shall act as the secretary to the committee.

(b) The auditor may take the following steps to ensure that the dividend has been paid only out of profits.

1. Check whether the dividend was declared out of profits arrived at after providing for depreciation.
2. If no depreciation has been provided, ensure that the approval was obtained from the Central Government before declaring dividend.
3. Check whether

(i) The depreciation was provided according to provision of section 205(2).

(ii) The minimum prescribed amount has been transferred to reserves before declaring any dividend.

(iii) Conditions governing transfer of higher percentage is complied with.

(iv) A board resolution recommending dividend was passed.

(v) Dividend was declared (resolution was passed) only in the Annual General Meeting.

(vi) Dividend has been paid in the prescribed manner within 30 days of time to the registered holder or their order.

(vii) Amount of dividend deposited in a separate bank account within five days from the date of declaration of dividend.

(viii) Permission of Reserve Bank of India has been obtained for payment to nonresident shareholders before the remittance of dividend to their account.

(ix) Intimation sent to Stock Exchange in the case of listed company.

(x) There were any complaints of non payment/delayed payment of dividend and the corrective action taken.

8. (a) *As the auditor of LMN Ltd. you notice certain differences in the figures between the books of account and offer document. The company explains that it is due to certain adjustments made as per SEBI (Disclosure and Invertor Protection) Guideline, 2000. State such disclosure and adjustments which are to be incorporated in the Financial Statement of the offer document.*

(b)(i) *Is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employees State Insurance, Income Tax, Sales Tax, Wealth Tax, Customs duty, Excise duty, Cess and any other statutory dues with the appropriate authorities and if not, the extent of arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable shall be indicated by the auditor.*

(ii) *Whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty percent of its net worth and whether it has incurred cash losses in such financial year and in the immediately proceeding financial year.*

ANSWER

(a) SEBI (Disclosure and Investor Protection) Guidelines, 2000 require following disclosure and adjustment in the financial statement which is to be incorporated in the offer document:

(a) All significant accounting policies and standards followed in the preparation of the financial statement shall be disclosed.

(b) Statement of assets and liabilities and profit and loss or any other financial information shall be incorporated after making the following adjustments, wherever quantification is possible.

(i) Adjustments/rectification for all incorrect accounting policies or failures to make provisions or other adjustments which resulted in audit qualifications.

(ii) Material amount relating to adjustments for previous years shall be identified and adjusted in arriving at the profit for the year to which they relate, irrespective of the year in which the event triggering the profit or loss occurred.

(iii) Where there has been change in accounting policy, the profits or losses of the earlier years and of the year in which the change has taken place shall be recomputed to reflect what the profits or losses would have been if a uniform accounting policy was followed in each of these years. However, if an incorrect accounting policy is being followed the recomputation of the financial statement would be in accordance with correct accounting policies.

(iv) Statement of profit or loss shall disclose both the profit and loss before and after considering the profit or loss from extraordinary items.

(v) The statement of assets and liabilities shall be prepared after deducting the balance outstanding on revaluation reserve account from both fixed assets and reserve and the net worth arrived at after such deduction.

(b) (i) (1) The auditor has to report upon regularity of the company in depositing undisputed statutory dues.

(2) If the company is not regular in depositing the undisputed statutory dues the auditor has to state the extent of arrears of statutory dues which have remained outstanding as at the last day of the financial year.

(3) The payment includes all other statutory dues payable by the company.

(4) The amount payable will include the interest/penalty payable under the respective laws.

(5) The auditor has to get a written representation from the management indicating the details of disputed claims, undisputed but have remained outstanding for more than six months and a statement as to the completeness of the information provided by the management.

(b) (ii) 1. This clause is applicable to all the companies which are in existence for more than five years.

2. The auditor has to report (i) whether the accumulated losses at the end of the financial year are more than 50% of its net worth and (ii) whether the company has incurred cash losses during the period covered by the report and in the immediate previous year.

3. The term loss should be construed to mean the net profit/loss shown by the P & L a/c of the company as adjusted after taking into account qualifications in the audit report to the extent qualifications are quantified.

4. Net worth is defined as sum of total paid up capital and free reserves after deducting the provisions or expenses as may be prescribed.

5. Free reserve means all reserves created out of profits and share premium but does not include reserves created out of revaluation of assets, write back of depreciation provisions and amalgamation.

6. The auditor has to indicate his opinion on the above and the effect of qualifications.

9. *Write short notes on the following:*

(a) *Circuit filters/Circuit breakers.*

(b) *General principles relating to propriety aspect.*

(c) *Frauds through supplier ledger.*

(d) *Purpose of appointing Inspecting officer of a Depository.*

ANSWER

(a) Circuit Filters/Circuit Breakers:

(i) This is the price band that set the upper and lower limit within which a stock can fluctuate on any particular day.

(ii) A price band for a day is a function of the previous days closing price.

(iii) According to SEBI directions circuit filter is applied on scrips traded in rolling settlement, if their price fluctuate more than 10% of the closing price of scrip on the previous day.

(iv) Thus circuit filters restrict extreme price movement and resist price manipulation.

(v) This also protects investor from extreme fluctuations.

(b) General principles to be confirmed by Propriety

(i) The expenditure is not prima facie more than the occasion demands and that every official exercises the same degree of vigilance in respect of expenditure as a person of ordinary prudence.

(ii) That the authority exercises its powers of sanctioning expenditure which will not result in any benefit directly or indirectly to such authority.

(iii) That the funds are not utilised for the benefit of a particular person or group of persons and

(iv) That, apart from the agreed remuneration or reward, no other revenue is kept open to indirectly benefit the management personnel, employees or others.

(c) Frauds though suppliers ledger : Fraud through supplies ledger could be made in any of the following ways, which the auditor has to take case of:

(1) Adjusting fictitious as duplicate invoices as purchases in the accounts of suppliers and subsequently misappropriating the money when payments are made in respect of these invoices.

(2) Suppressing credit notes issued by suppliers and withdrawing the corresponding amount not claimed by them.

(3) Withdrawing amounts which remain unclaimed for more than the normal time limit for one reason or other by showing the same have been paid to the parties.

(4) Accepting invoices at prices considerably highest than the market price and collecting the excess claim from the suppliers directly.

(d) SEBI appoints inspecting officers to investigate or inspect the affairs of a depository for any of the following purposes.

(1) To ensures that the books of accounts are maintained in the names specified in the regulations

(2) To look into the complaints received from depositors' participant, beneficial owners or other persons.

(3) To ascertain whether the provisions of the Act, bye-laws agreements and these regulations are being complied.

(4) To ascertain whether the systems, procedures and safeguards are being followed in the interests and to secure the market.

(5) To ensure that the affairs are being conducted in the interest of the Investors / Securities markets.

10. *Answer the following:*

(a) *Mention the difference between 'report' and 'certificate.'*

(b) *What are the contents of reports and certificates for special purposes?*

(c) *What are the reporting requirements for closing stocks in the Manufacturing and other Companies (Auditors Report) Order, 1988?*

ANSWER

(a) ***Difference Between Report and Certificate***: A certificate is written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. A report on the other hand, is a formal statement usually made after an enquiry, examination or reviews of specified matters under report and includes the reporting auditor's opinion thereon. These words are fundamentally distinct from each other. Etymologically, the word 'certificate' is derived from Latin words certus (Certain) and facere (to make). So, the certificate connotes verification of certain and exact facts. However, the rendition of this type of statement is an impossible task and the auditor's duty indeed becomes onerous. The dictionary meaning of the word 'report' refers to formal account of results after an enquiry, examination or review given by an authorised person or group of reasons.

In other words, when a certificate is issued, the auditor is responsible for the factual accuracy of what is contained therein. However, when a report is given, the auditor is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts and that it is arrived at by the application of due care and skill.

(b) ***Contents of Reports and Certificates for Special Purposes***: The contents of reports and certificates for special purposes in many cases are specified by statute and cannot be changed. However, in cases where no format has been specified, the reporting auditor can choose the form and contents. In such cases, where a reporting auditor is free to draft his report or certificate, he should consider the following:

1. Specific elements, accounts or items covered by the report or certificate should be clearly identified and indicated.
2. The report or certificate should indicate the manner in which the audit was conducted, e.g., by the application of generally accepted auditing practices, or any other specific tests.
3. If the report or certificate is subject to any limitations in scope, such limitations should be clearly mentioned.
4. Assumptions on which the special purpose statement is based should be clearly indicated if they are fundamental to the appreciation of the statement.
5. Reference to the information and explanations obtained should be included in the report or certificate. In certain cases apart from a general reference to information and explanations obtained,

a reporting auditor may also find it necessary to refer in his report or certificate to specific information or explanations on which he has relied.

6. The title of the report or certificate should clearly indicate its nature, i.e., whether it is a report or a certificate. Similarly, the language should be unambiguous, i.e., it should clearly bring out whether the reporting auditor is expressing an opinion (as in the case of a report) or whether he is only confirming the accuracy of certain facts (as in the case of a certificate). For this, the choice of appropriate words and phrases is important.
7. If the special purpose statement is based on general purpose financial statements, the report or certificate should contain a reference to such statements. However, the report or certificate should not contain a reference to any other statement unless the same is attached therewith. It should be clearly indicated whether or not the statutory audit of the general purpose financial statements has been completed and also, whether such audit has been conducted by the reporting auditor or by another auditor. In case the general purpose financial statements have been audited by another auditor, the reporting auditor should specify the extent to which he has relied on them. He may communicate with the statutory auditor for securing his cooperation and in appropriate circumstances, discuss relevant matters with him, if possible.
8. Where a report requires the interpretation of a statute, the reporting auditor should clearly indicate the fact that he is merely expressing his opinion in the matter. He should take sufficient care to ensure that in respect of matters which are capable of more than one interpretation, his report is not misconstrued as representing a settled legal position.
9. An audit report or certificate should ordinarily be a self-contained document. It should not confine itself to a mere reference to another report or certificate issued by the reporting auditor but should include all relevant information contained in such report or certificate.
10. The reporting auditor should clearly indicate in his report or certificate, the extent of responsibility which he assumes. Where the statement on which he is required to give his report or certificate, includes some information which has not been audited, he should clearly indicate in his report or certificate the particulars of such information.

In certain cases, the form and/or contents of the report or certificate, as prescribed by a statute or a notification, may not be appropriate or adequate. In such situations, the reporting auditor may consider modifying the report or certificate on the basis of the aforesaid parameters, to the extent applicable. In case this is not possible, he should clearly indicate the limitations in his report or certificate itself.

(c) *Reporting Requirements for Closing Stocks Under MAOCARO, 1988*: The auditor has to make four specific statements on verification and valuation of closing stocks under MAOCARO, 1988 issued under Section 227(4A) of the Companies Act, 1956. The Order requires the auditor to state "whether physical verification has been conducted by the management at reasonable intervals in respect of finished goods, stores, spare parts and raw materials". Secondly, the auditor has to state, "Are the procedures of physical verification of stocks followed by the management reasonable and adequate in relation to the size of the company and the nature of its business? If not, the inadequacies in such procedures should be reported".

Further, "whether any material discrepancies have been noticed on such verification as compared to book records, and if so, whether the same have been properly, dealt with in the books of account". Finally, "whether the auditor is satisfied on the basis of his examination of stocks that such valuation is fair and proper in accordance with the normally accepted accounting principles. Is the basis of valuation of stocks same as in the preceding year? If there is any deviation in the basis of valuation, the effect of such deviation, if material, should be reported".

The comment on the reasonableness and adequacy of the stock verification procedures requires that the auditor should examine the methods and procedures of such verification and may, if considered appropriate by him, be also present at the time of stock-taking. He should, in any case, examine the instructions given by the management to the stock-taking personnel (which should preferably be in writing).

Where stocks are material and the auditor is placing reliance on the physical verification by the management, it may be appropriate for the auditor to attend stocktaking and perform test counts. He should ascertain whether the cut-off procedures are adequate. The original physical verification sheets should be reviewed and selected items traced into final inventories, which in turn should be compared with stock records and other evidence such as stock statements submitted to banks. The procedures for identifying damaged and obsolete items of inventory should be reviewed. While commenting on this clause, the auditor should point out the specific areas where the procedures are not reasonable or adequate.

The auditor should look carefully into all material discrepancies between the book stocks and physical and physical inventories to examine whether the same have been properly adjusted in the books of account. The auditor has also state whether the valuation of stocks is fair and proper in accordance with the normally accepted accounting principles. To determine what constitute the normally accepted accounting principles regarding valuation of stock, one may refer to Accounting Standard 2. This standard provides that, in general, inventories should be valued at the lower of historical cost and net realisable value.

11. *State your views as an auditor on the following:*

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

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

ANSWER

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

1. The articles of association should permit distribution of capital profits.
2. The capital profit which is sought to be distributed should have actually been realised. Unrealised capital profits, e.g., those arising on a revaluation of fixed assets, cannot be distributed as dividends. However, if the assets so revalued are subsequently sold, the amount realised over and above. the original cost of such assets is a capital profit available for distribution as dividend (provided the other conditions are satisfied).
3. The capital profit should remain after a proper valuation has been fairly taken of the whole of the assets and liabilities. In other words, any fall or deficiency in the value of other assets or appreciation in the amount of liabilities should be deducted from the amount of capital profits to ascertain the amount which can properly be regarded as distributable as dividend.

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

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

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

12. *Comment on the following with reference to the Chartered Accountants Act, 1949, Code of Ethics and Schedules to the Act:*

(a) *P, a Chartered Accountant in practice provides management consultancy and other services to his clients. During 2005, looking to the growing needs of his clients to invest in the stock markets, he also advised them on Portfolio Management Services whereby he managed portfolios of some of his clients.*

(b) *B, a Chartered Accountant in practice is a partner in 3 firms. While printing his personal letter heads, B gave the names of all the firms in which he is a partner.*

(c) *XYZ & Associates, a firm with 5 partners developed a website www.xyzassociates.com. The website also contained a link to "All India Chartered Accountants Association", a voluntary association where X, a partner of the firm is currently the Vice-president.*

(d) *M/s LMN, a firm of Chartered Accountants responded to a tender from a State Government for computerization of land revenue records. For this purpose, the firm also paid Rs.50,000 as earnest deposit as part of the terms of the tender.*

ANSWER

(a) Advising on Portfolio Management Services: The Council of the Institute of Chartered Accountants of India (ICAI) pursuant to section 2(2)(iv) of the Chartered Accountants Act, 1949 has passed a resolution permitting "*Management Consultancy and other Services*" by a Chartered Accountant in practice. A clause of the aforesaid resolution allows Chartered Accountants in practice to act as advisor or consultant to an issue of securities including such matters as drafting of prospectus, filing of documents with SEBI, preparation of publicity budgets, advice regarding selection of brokers, etc. It is, however, specifically stated that CAs in practice are not permitted to undertake the activities of broking, underwriting and portfolio management Services. Thus, a chartered accountant in practice is not permitted to manage portfolios of his clients. In view of this, P would be guilty of misconduct under the Chartered Accountants Act, 1949.

(b) Advertisement of Professional Attainments: Clause 7 of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public. Even a member is not permitted to specify the date of setting up of practice or establishment of firm. However, there is no prohibition for printing names of all the three firms on the personal letterheads in which a member holding Certificate of Practice is a partner. Thus B is not guilty of any misconduct under the Chartered Accountants Act, 1949.

(c) Developing Website: As per the guidelines laid down under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 in respect of websites by chartered accountants in practice, it is permitted that website may provide a link to the website of ICAI, its Regional Councils, Branches and Government Departments and other professional Bodies like AICPA, ICAEW, CICA. In this case, M/s XYZ Associates provided a link to "All India Chartered Accountants Association" which is not permitted. Hence the firm would be liable for misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(d) Responding to Tenders: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 lays down guidelines for responding to tenders, etc. As per the guidelines if a matter relates to any services other than audit, members can respond to any tender. Further, in respect of a non-exclusive area, members are permitted to pay reasonable amount towards earnest money/security deposits. In the instance case, since computerization of land revenue records does not fall within exclusive areas for chartered accountants, M/s LMN can respond to tender as well as deposit Rs.50,000 as earnest deposit and shall not have committed any professional misconduct.

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

(a) *A chartered accountant in practice created his own website in attractive format and colours and circulated the information contained in the website through E-mail.*

(b) *A chartered accountant in practice takes up the appointment as managing director of a public limited company.*

(c) *S. a practicing chartered accountant gives power of attorney to an employee chartered accountant to sign reports and financial statements, on his behalf.*

(d) *A is the auditor of Z Ltd., which has a turnover of Rs. 200 crore. The audit fee for the year is fixed at Rs. 50 lakhs. During the year, the company offers A an assignment of management consultancy within the meaning of Section 2(2)(iv) of the CA Act, 1949 for a remuneration of Rs. 1 crore. A seeks your advice on accepting the assignment.*

ANSWER

(a) ***Creation of own website by a chartered accountant/firm of chartered accountants*** : The guidelines approved by the Council of the Institute of Chartered Accountants of India permits creation of own website by a chartered accountant in his or his firm name and no standard format or restriction on colours is there. The chartered accountant or firm, as per the guidelines, should ensure that none of the information contained in the website be circulated on their own or through E-mail or by any other mode except on a specific "Pull" request. Since in the given case, the chartered accountant circulated the information contained in the website through E-mail, he is guilty of misconduct under clause 6 of Part I of the First Schedule to the Chartered Accountants Act, ie., a chartered accountant in practice is deemed to be guilty of professional misconduct if he solicits client or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means.

(b) ***Appointment of a CA in practice as MD of a Public Limited Company***: Under clause 11 of Part I of First Schedule to the Chartered Accountants Act, a chartered accountant in practice is deemed to be guilty of professional misconduct, if he engages in any business or occupation other than the profession of chartered accountants, unless permitted by the council so to engage.

However, nothing contained in clause 11 shall disentitle a chartered accountant from being a director of a company, unless he or any of his partners is interested in such company as an auditor. Regulation 190A, states a member in practice cannot engage himself in any business or occupation other than that of a chartered accountant except when permitted by the council. As per Appendix 10 of CA Regulations, 1988, a CA in practice may hold the office of a Managing Director a Whole Time Director of a body corporate, provided that the member and/or his relatives do not hold substantial interest in such concern, after obtaining the specific and prior approval of the Council. He should seek prior approval of the council otherwise he would be held guilty of misconduct.

(c) ***Power of signing reports and financial statements:*** Under clause 13 of Part I of First Schedule to the Chartered Accountants Act a CA in practice is deemed to be guilty of professional misconduct if he allows a person not being a member of the Institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements. This clause read in conjunction with Section 26 of the CA Act 1949 stipulates that no person other than the member of the institute shall sign any document on behalf of a CA in practice or a firm of CA' s in his or its professional capacity. The term 'Financial Statement' for this purpose would cover an examination of the accounts or financial statements given under a statutory enactment or otherwise. Accordingly S is guilty of professional misconduct under clause 13 of part I of First Schedule and also under clause (1) of Part II of Second Schedule for contravening Section 26.

(d) *Appointment as a statutory auditor of a PSUs'/Govt company(ies)/listed company(ies) and other public company(ies)* : In exercise of the powers conferred by clause (ii) of part II of the Second Schedule to the CA Act, 1949, the Council of ICAI specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct if he accepts the appointment as a statutory auditor of a PSUs'/Govt company(ies)/listed company(ies) and other public company(ies) having a turnover of Rs. 50 crores or more in a year and accepts any other work(s) or assignment(s) or service(s) in regard to same undertaking(s) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same undertaking. In view of the above position it would be a misconduct on A's part if he accepts the management consultancy assignment for a fee of Rs. 1 crore.

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

***(a)** A Pvt. Ltd., started stock broking activities in 2005. For this purpose it acquired membership of a stock exchange for Rs.110 lacs. While finalizing the accounts, the company disclosed the above amount under the Fixed Assets schedule as "Stock Exchange Membership Rights". The company also did not write off any amount since the rights would enable the company to perpetually carry on its business. (5 Marks)*

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

***(c)** XYZ Ltd. had received a grant of Rs. 50 lacs in 1997 from a State Government towards installation of pollution control machinery on fulfillment of certain conditions. The company, however, failed to comply with the said conditions and consequently was required to refund the said amount in 2005. The company debited the said amount to its machinery in 2005 on payment of the same. It also reworked the depreciation for the said machinery from the date of its purchase and passed necessary adjusting entries in the year 2005 to incorporate the retrospective impact of the same.*

***(d)** C Ltd. holds shares of D Ltd. which also entitles it to 51% voting power. These shares are held as "Stock-in-Trade" since C Ltd.'s intention is to dispose them in the near future. Due to this, C Ltd. Is of the view that the financial statements of D Ltd. need not be consolidated.*

ANSWER

(a) *Stock Exchange Membership Rights*: A Pvt. Ltd. has paid Rs.110 lacs for acquiring membership of stock exchange. Such membership rights provide exclusive right to A Pvt. Ltd. for carrying out stock broking activities. Thus, Stock Exchange Membership Rights are controlled by A Pvt. Ltd. and provide the basis for generating economic benefits to it. All these criteria appear to meet the definition of intangible assets as laid down in AS 26, "*Intangible Assets*". The Standard requires an entity to recognize an intangible asset if it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise and the cost of the asset can be measured reliably.

In the instant case, membership rights of stock exchange acquired by A Pvt. Ltd. Meet the criteria of identifiability, control and arising of future benefits as well as reliability of the amount of cost. Thus recognizing the membership rights as Fixed Assets is proper. However, the fact that the company did not write-off any amount since it would enable the company to perpetually carry on its business is not proper since AS 26 requires that all Intangible Assets to be amortised. For this purpose, a rebuttable presumption of 10 years is to be considered. Hence in the instant case, the company should have amortised such rights over

10 years. Since the company has not amortised any amount, the auditor will have to qualify his report and state the fact of non-compliance with AS 26.

(b) ***Declaration of Dividends***: ABC Ltd. earned a total net profit of Rs.1 crore for three years 2001-02 to 2003-04 but it did not declare any dividend nor transferred any amount to Reserves for these three years. Since it did not declare any dividend, there was no compulsion to transfer any amount to Reserves. It appears that the company has retained the profit of previous years as "surplus" under the heading of "Reserves & Surplus". ABC Ltd. wants to declare dividend of Rs. 25 lacs for the financial year 2004- 05, which works out to 25% of its paid up capital. However, since this rate of dividend exceeds 20% of the paid up share capital, as per the requirements of Companies (Transfer of Profit to Reserves) Rules, 1975, the company should transfer at least 10% of its current profit that is Rs.2 lacs to reserves resulting into deficiency of Rs. 7 lacs in the amount of current profit which could be available for the purpose of distribution of dividend. The company, however, is well within its power to cover the said deficiency of profit out of its accumulated profit in spite of restrictions laid down in the rules prescribed under section 205A (3) of the Act, viz., Companies (Declaration of Dividend out of Reserves) Rules, 1975, since the company had not transferred any of its profit for the years 2001- 2002 to 2002-04 to reserves. Thus, the company is well within its powers and right to declare the dividend of Rs.25 lacs for the year 2004-05.

(c) ***Refund of Government Grant:*** As per facts of the case, XYZ Ltd. had received a grant of Rs. 50 lacs in 1997 from a State Government towards installation of pollution control machinery on fulfillment of certain conditions. However, the amount of grant has to be refunded since it failed to comply with the prescribed conditions. In such circumstances, AS 12, "*Accounting for Government Grants*", requires that the amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. The Standard further makes it clear that in the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset. Accordingly the accounting treatment given by XYZ Ltd. of increasing the value of the plant and machinery is quite proper. However, the accounting treatment in respect of depreciation given by the company of adjustment of depreciation with retrospective effect is improper and constitutes violation of both the AS 6, "*Depreciation Accounting*" and AS 12, "Accounting for Government Grants". The auditor, therefore, should discuss with the management to make necessary changes in respect of same and if not agreed to, qualify the report quantifying the impact of the same on profit as well as assets of the company.

(d) ***Consolidation of Accounts***: AS 21, "*Consolidated Financial Statements*", requires that a subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future. In this case it needs consideration as to whether C Ltd.'s intention is to dispose off shares or hold the same. Since shares are being held as 'stock-in-trade' and the intention is to dispose off in near future, it is quite clear that control is temporary. Accounting Standards Interpretation issued by the Institute of Chartered Accountants of India specifies that where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise would be considered temporary. Hence in a such a case the concerned subsidiary should be excluded from consolidation. Therefore, the contention of the C Ltd. that D Ltd. can be excluded from consolidation is correct.

***15.** Comment on the following:*

***(a)** 'A' Limited has paid minimum alternate tax under Section 115 JB of the Income Tax Act, 1961, for the year ended 31st March, 2009. The company wants to disclose the same as an 'Asset' since the company is eligible to claim credit for the same.*

***(b)** XYZ Limited received a grant of Rs.25 lakhs under the Government's Subsidy Scheme, for acquiring an imported machinery for setting up new plant. The entire grant received is credited to Profit and Loss Account.*

***(c)** Moon Limited replaced its statutory auditor for the Financial year 2008-09. During the course of audit, the new auditor found a credit item of Rs.5 lakhs. On enquiry, the company explained him that it is, a very old credit balance. The creditor had neither approached for the payment nor he is traceable. Under the circumstances, no confirmation of the credit balance is available.*

***(d)** The statutory audit of Fortune Limited for the year ended on 31.03.2009 was completed and auditor also submitted his report with the audited Financial Statements to the management of the company. Thereafter, the management of the company approached the auditor to revise certain items in the Financial Statements.*

ANSWER

(a) As per para 6 of the Guidance Note issued by ICAI on "*Accounting for credit available in respect of MAT under the IT Act, 1961*", although MAT credit is not a deferred tax asset under AS 22, yet it gives rise to expected future economic benefit in the form of adjustment of future income tax liability arising within the specific period. The Framework for the preparation and presentation of financial statements, issued by the ICAI, defines the term 'asset' is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise. MAT paid in a year in respect of which the credit is allowed during the specified period under the Income Tax Act is a resource controlled by the company as a result of past event, namely the payment of MAT. The MAT credit has expected future economic benefits in the form of its adjustment against the discharge of the normal tax liability if the same arises during the specified period. Accordingly, such credit is an asset. According to the Framework, once an item meets the definition of the term 'Asset', it has to meet the criteria for recognition of an asset, so that it may be recognised as such in the financial statements. Para 88 of the Framework provides the following criteria for recognition of an asset: An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably. Thus, if the auditor is satisfied that the probability of the company to claim the said credit is high, it could recognise the same as an asset. In balance sheet it could be shown under the head "Loans and Advances" as MAT credit entitlement.

(b) According to AS 12, "*Accounting for Government Grants*" where grant is received for the acquisition of a specific fixed asset, the same cannot be credited to Profit and Loss Account since it fails to match revenue with the cost. As per AS 12, such grants should be presented in the balance sheet showing the grant as a deduction from the gross value of the asset concerned (in arriving at its book value). Alternately, the grants related to a depreciable fixed asset may be treated as deferred income which should be recognised in the profit and loss account on a systematic and rational basis over the useful life of the asset. By crediting the entire amount of grant to profit and loss account, the company has treated it as a revenue income which is not in accordance with the requirements of the accounting standard. Therefore, the statutory auditor would have to qualify appropriately that the income has been overstated to the extent of the amount of grant net of proportionate credit that would have been worked out.

(c) This is a case of external confirmation, covered by SA 505 "*External Confirmation*". The identities of creditors are not traceable to confirm the credit balance as appearing in the financial statement of the company. It is also not a case of pending litigation. It might be a case that an income of Rs.4 lakhs had been hidden in previous year/s. The statutory auditor should examine the validity of the credit balance as appeared in the company's financial statements. He should obtain sufficient evidence in support of the balance. He should apply alternative audit procedures to get documentary proof for the transaction/s and should not rely entirely on the management representation. Finally, he should include the matter by way of a qualification in his audit report to the members.

(d) As per the Guidance Note on Revised Accounts of Companies Before Circulation to Shareholders, management can revise its accounts after adoption on which report has been issued by the Auditors, but before circulation to the shareholders. In the instant case, the statutory auditor should ascertain whether the original audit report along with audited accounts has been circulated to the share-holders. If not, he can issue a revised report on the amended financial statements as laid down by the said Guidance Note:

- For the same, the revised accounts must be re-approved by the Board of Directors of the company.
- He should ask the company to return all the original copies of the earlier audit report along with the audited accounts.
- The fact of revision of financial statements with reasons should be incorporated in the Directors' Report. If it is neither included nor found adequately disclosed in the Director's Report, he should include the fact with figures and reasons in his revised audit report to the shareholders. He should specifically mention that it is a revised audit report.

***16.** You are confronted with the following situations as an auditor. How would you deal with them?*

***(a)** A company has established several plants at different places in India and ends the accounting year on 31st March. Recently it has established another plant which went into commercial production on 1st July and wants to adopt a separate accounting year for the newly established plant.*

***(b)** A company wants to adjust the bank balance on the balance sheet date by reversing the entry for a cheque issued in the normal course of business and cancelled after the year end but before the finalisation of accounts. The cheque was returned on the ground that the signature differs.*

***(c)** As a branch auditor would you insist on approval of final accounts by the board of directors before submitting your report though the board refuses to do so and informs you that an authorised official will approve them.*

ANSWER

(a) Section 210 of the Companies requires the Board of Directors of every company to lay before the AGM a balance sheet as at the end of the financial year and a profit and loss account for the period comprised in the financial year. Hence it is clear that for each company as a separate entity only one financial year can be there. Section 210(3) does not give scope for a company to adopt different accounting years for the segments constituted within the company. In the given problem it is clear that the new plant which went into commercial production on 1st July is a part and parcel of the existing company which alone is the entity recognised for the purpose of complying with Section 210. Hence it cannot have a different accounting year other than the one adopted by the company though flexibility in this regard exists under the Income-tax Act.

(b) According to the Accounting Standard 4 entitled Contingencies and Events Occurring After the Balance Sheet Date issued by the ICAI, assets and liabilities should be adjusted for significant events occurring after the balance sheet date that provide additional evidence to assets estimation of amounts relating to conditions existing at the balance sheet date. Since the phenomenon of difference in signature existed on the balance sheet due (though known afterwards); the reversal of the entry can be made as on the balance sheet date if the amount is material.

(c) Section 228(3)(b) of the Companies Act, 1956 provides that the branch auditor "shall have the same powers and duties in respect of the accounts of the branch office as the company's auditor has in respect of the same". Section 215(3) of the Companies Act states that the balance sheet and the profit and loss account of the company shall be approved by the Board of Directors before they are signed on behalf of the Board in accordance with the provisions of this Section before they are submitted to the auditors for their report thereon. The approval of accounts by an authorised official seems to be good enough for acceptance of the accounts.

***17. (a)** Trimurthy Pan Masala (P) Ltd. was incurring heavy losses in the last several years since it could not withstand the competition in the market. The State in which the company had its registered office and also its major sales had moved a bill in the State Assembly to ban manufacture and sale of all kinds of Pan Masalas in the State. While finalizing the accounts for the year ended 31-03-2004, the CFO of the company created a Deferred Tax Asset for the tax benefits that would arise in future years from the earlier years losses that had remained unabsorbed in Income Tax*

***(b)** Big Ltd. has borrowed Rs. 30 lakhs from State Bank of India during the financial year 2003-04. The borrowings are used to invest in shares of Small Ltd., a subsidiary company of Big Ltd., which is implementing a new project estimated to cost Rs. 50 lakhs. As on 31st March, 2004, since the said project was not complete, the directors of Big Ltd. resolved to capitalize the interest accruing on borrowings amounting to Rs. 4 lakhs and add it to the cost of investments.*

ANSWER

(a) *Creation of Deferred Tax Asset:* Accounting Standard 22 on "*Accounting for Taxes*" requires that Deferred Tax Asset (DTA) should be recognised for all timing differences, subject to the considerations of prudence. The Standard further states that unabsorbed losses of the business can be considered for creation of DTA provided there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such DTA can be realised. In view of this, the DTA created by the CFO of Trimurthy Pan Masala (P) Ltd. is not in order. Since the company which is in the business of manufacturing of *panmasala* has been incurring heavy losses and in addition to this the State in which the company is having its major sales is proposing the ban on sale and manufacture of pan masala, the statutory auditor would, therefore, have to qualify his report and mention the extent of amounts of loss and reserves which are under and overstated respectively.

(b) *Capitalisation of Interest:* As per AS 13 on "*Accounting for Investments*", the cost of investment includes acquisition charges such as brokerage, fees and duties. In the instant case, Big Ltd. has used borrowed funds for purchasing shares of its subsidiary company Small Ltd. Rs. 4 lakhs interest payable by Big Ltd. to State Bank of India can not be called as cost of investment. The Accounting Standard 16 on "*Borrowing Costs*" also does not consider investment in shares as qualifying asset that can enable a company to add the borrowing costs to investments. In the instant case, the statutory auditor would qualify his report by stating that the borrowing costs have been wrongly added to the cost of investments rather than charging them to profit and loss account. The effect of the same on the profits for the year would also have to be mentioned.

***18.** Answer the following:*

***(a)** What are the areas in which Due Diligence can take place ?*

***(b)** What are the steps to be taken by a firm of Chartered Accountant to ensure that its appointment as Statutory Auditor of a Company is valid?*

***(c)** As the tax auditor of a Company, how would you report on payments exceeding Rs 20,000 made in cash to a supplier against an invoice for expenses booked in an earlier year?*

ANSWER

(a) *Areas in which Due Diligence can take place* :

1. Commercial/operational due diligence: It is generally performed by the concerned acquire enterprise involving an evaluation from commercial, strategic and operational perspectives. For example, whether proposed merger would create operational synergies.

2. Financial Due Diligence: It involves analysis of the books of accounts and other information pertaining to financial matters of the entity. It should be performed after completion of commercial due diligence.
3. Tax Due diligence: It is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence .The accountant has to look at the tax affect of the merger or acquisition.
4. Information systems due diligence: It pertains to all computer systems and related matter of the entity.
5. Legal due diligence: This may be required where legal aspects of functioning of the entity are reviewed. For example, the legal aspects of property owned by the entity or compliance with various statutory requirements under various laws.
6. Environmental due diligence: It is carried out in order to study the entity's environment, its flexibility and adaptiveness to the acquirer entity.
7. Personnel due diligence: It is carried out to ascertain that the entity's personnel policies are in line or can be changed to suit the requirements of the restructuring.

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

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

(c) Reporting of payments exceeding Rs. 20000 in cash: Such reporting is required to be done while conducting the tax audit u/s 44AB of the Income Tax Act, 1961 in Form 3CD with effect from A. Y. 2008-09. The tax auditor shall have to report for clause 17 (h) for the above as per the amended section 40 A(3) of the Income Tax Act, 1961.

In the instant case the invoice for expenses has been booked in an earlier year. However, since payment for the same is made during the current year by cash exceeding Rs. 20000, the reporting thereof would be necessary in clause 17(h) of Form 3CD. The sub-clause (h) required furnishing of the amount inadmissible under section 40A(3) read with rule 6 DD along with computation. The entire amount paid as above, is likely to be disallowed u/s 40 A(3) of the Income Tax Act, 1961.

***19.** Answer the following:*

***(a)** Designing an Audit Strategy is the backbone of the "Audit Planning" process. Discuss.*

***(b)** As a Statutory Auditor, of a bank, how would you verify the "Sacrifice" on Non- Performing Assets for which Corporate Debt Restructuring has been undertaken?*

ANSWER

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

(i) Obtaining Knowledge of Business: AAS 20, "Knowledge of Business", states that in performing an audit of financial statements, the auditor should have or obtain knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgement, may have a significant effect on the financial statements or on the examination or audit report. Knowledge of the business is a frame of reference within which the auditor exercises professional judgement.

Understanding the business and using this information appropriately assists the auditor in assessing risks and identifying problems, planning and performing the audit effectively and efficiently. It also ensures that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to enable them to carry out the audit work delegated to them. This would also ensure that the audit staff understands the need to be alert

for additional information and the need to share that information with the auditor and the other audit staff.

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

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

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

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

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

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

(b) *Corporate Debt Restructuring and Sacrifice Element*: The Revised Guidelines on Corporate Debt Restructuring (CDR) Mechanism specified that in case of rescheduling of accounts, the element of interest to be computed in present value terms. The guidelines state that the sacrifice should be computed as the difference between the present value of future interest income reckoned based on the current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring and the interest charged as per the restructuring package discounted by the current BPLR as on the date of restructuring plus appropriate term premium and credit risk premium as on the date of restructuring. Accordingly, the following steps may be taken in this regard:

1. Check that the appropriate credit risk premium for the specific borrower category for all restructured accounts.

2. Ascertain appropriate rate of discount.
3. Check the computation of present value interest and the sacrifice amount.
4. See that the entire amount should be written off or provided for in case sacrifice is positive.
5. Verify provision of adequate security coverage of the loan in case restructuring of principal amounts.

20. *Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules there to:*

(a) *CA X was appointed as the Auditor of ABC Ltd. for 2007-08. Since he declined to accept the appointment, the Board of Directors appointed CA Y as the auditor in the place of CA X, which was also accepted by CA Y.*

(b) *CA Z who is a leading Income Tax Practitioner and consultant in Jaipur is also trading in derivatives.*

(c) *CA D, a Chartered Accountant prepared a project report for one of his clients to obtain bank finance (long-term) of Rs.50 lakhs from a Commercial Bank. Consequent to the sanction of the loan by the bank CA D raised a bill for his services @2% of the loan sanctioned.*

(d) *CA ZZ who conducted ABC audit of a marathi daily 'New Era' certified the circulation figures based on Management Information System Report (M.I.S Report) without examining the books of Account.*

ANSWER

(a) 1. Board can appoint the auditor in the case of casual vacancy under Sections 224 (5) & 6(a) of the Companies Act, 1956.

2. The non-acceptance of appointment by CA. X does not constitute a casual vacancy to be filled by the Board.

3. In this case, it will be deemed that no auditor was appointed in the AGM.

4. Hence the appointment of auditor can be made only by the Central Government and the Board appointment is defective in law.

5. Clause 9 of Part-I of First Schedule states that a chartered accountant is deemed to be guilty of professional misconduct if he "Accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of section 225 of the Companies Act, 1956 in respect of such appointment have been fully complied with".

6. Hence CA. Y is guilty of professional misconduct since he accepted the appointment without verification.

(b) 1. As per clause 11 of Part-I of First Schedule of CA Act, 1949, a Chartered Accountant is deemed to be guilty of professional misconduct if he "engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage".

2. However, the Council has granted general permission to the members to engage in 12 specific occupations. In respect of all other occupations specific permission of the Institute is necessary.

3. In this case CA Z is engaged in the occupation of trading in derivatives which is not covered under the general permission.

4. Hence specific permission of the Institute has to be obtained otherwise he will be deemed to be guilty of professional misconduct under clause 11 of Part-I of First Schedule of CA Act, 1949.

(c) Clause 10 of part I to First Schedule to the Chartered Accountants Act prohibits a Chartered Accountant in practice to charge, to offer, to accept or accept fees which are based on a percentage of profits or which are contingent upon the findings or results of such work done by him. However, this restriction is not applicable where such payment is permitted by the
Chartered Accountants Act, the Council of the Institute has framed regulation 192 which exempts certain professional services from the operation of clause 10. The services rendered by CA. D are not covered under the said exemption and hence CA. D is liable for professional misconduct.

(d) 1. According to clause 7 of Part-I of Second Schedule of Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he "does not exercise due diligence or is grossly negligent in the conduct of his professional duties".

2. In the instant case CA ZZ did not exercise due diligence and is grossly negligent in the conduct of his professional duties since he certified the circulation figures without examining the books of accounts.

3. To ascertain the number of paid copies verification of remittances from the agents, credit allowed to the agents for unsold copies returned, examination of books of account is essential.

4. Further certification of circulation figures based on statistical information without cross verification with financial records amounts to gross negligence and failure to exercise due diligence.

5. Hence CA ZZ is guilty of professional misconduct as per clause 7 of part I of Second Schedule of Chartered Accountants Act, 1949.
