

PAPER – 3 : ADVANCED AUDITING

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

Question 1

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

- (a) Z Ltd. provided, Rs. 5 lakhs for inventory obsolescence in the last year's accounts. In the subsequent year, it was determined that 50% of this stock was actually usable. The Company wants to adjust the same as a "Prior period adjustment." (5 Marks)
- (b) A company capitalises interest on borrowings incurred for holding investments by adding the same to the cost of investment every year. (4 Marks)
- (c) For the year ended 31<sup>st</sup> March, 2007, a company has paid Minimum Alternative tax under section 115 JB of the Income Tax Act, 1961. The company wants to disclose the same as an 'Asset' since the company is eligible to claim credit for the same. (5 Marks)
- (d) X Ltd. is engaged in manufacture of Cement. In the Profit and Loss Account for the year ended 31<sup>st</sup> March, 2007, it discloses its revenue from sales transactions (turnover) net of excise duty. The excise duty collected and paid on sales transactions and that related to difference between Closing stock and Opening stock is, however, disclosed in the "Notes to Accounts". (4 Marks)

Answer

- (a) As per Accounting Standard 5 "Net Profit or Loss for the period, Prior Period Items and Change in Accounting Policies", Prior period items are income or expenditure which arise in the current period as a result of errors or omissions in the preparation of the Financial Statements of one or more prior periods.

The write back of provision made in respect of inventories in the earlier year does not constitute prior period adjustment since it neither constitutes error nor omission but it merely involves making estimates based on prevailing circumstances when Financial Statements were being prepared.

An estimate may have to be revised -

- (i) If changes occur in the circumstances on which the estimate was based or
- (ii) as a result of new information, more experience or subsequent developments.

The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

A change in an accounting estimate may affect the current period only or both the current period and future periods. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

- (b) Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. As per AS-13 "Accounting for Investment", cost of investments includes acquisition charges such as brokerage, fees and duties. As per AS 16 "Borrowing Costs", borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Assets that are ready for their intended use or sale when acquired are not qualifying assets. Therefore such investment is not an qualifying assets, therefore interest cost of holding investments cannot be capitalized.

The decision of the Directors to capitalize the interest on borrowings is not proper. So the Auditor should qualify his report and state the financial effect of deviation from AS.

- (c) The concerned issue is discussed in the Guidance Note issued by ICAI on "Accounting for Credit available in respect of MAT under the IT Act 1961". As per para 6 of the said Guidance Note , Although MAT credit is not a deferred tax asset under AS 22 , yet it give rise to expected future economic benefit in the form of adjustment of future income tax liability arising within the specified period.

The Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI, defines the term 'asset' as follows:

"An 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. 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, MAT 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 recognized as such in the financial statements. Para 88 of the Framework provides the following criteria for recognition of an asset: an asset is recognized 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 recognize the same as an asset. In Balance sheet it should be shown under the head "Loans & Advances" as "MAT credit entitlement".

- (d) As per Accounting Standard Interpretation – ASI 14 ' Disclosure of Revenue from Sales Transactions' (Revised) issued by ICAI in Aug 2006, turnover should be disclosed as follows on the face of the statement of Profit & Loss:

|                    |           |
|--------------------|-----------|
| Turnover (Gross)   | XX        |
| Less : Excise duty | <u>XX</u> |
| Turnover (Net)     | XX        |

Further, the excise duty shown above should be the total duty except the duty related to the difference between closing stock & opening stock which should be recognized separately in the statement of profit and loss, with an explanatory note in the notes to accounts to explain the nature of the two amounts of excise duty.

Since the company, X Ltd has not followed the above ASI 14, the auditor would have to qualify his report accordingly.

### Question 2

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

- (a) Mr. A, a practicing Chartered Accountant agreed to select and recruit personnel, conduct training programmes for and on behalf of a client. (5 Marks)
- (b) XY & Co., a firm of Chartered Accountant having 2 partners X & Y, one in charge of Head Office and another in charge of Branch at a distance of 80 kms, puts up a name-board of the firm in both premises and also in their respective residences. (5 Marks)
- (c) A practicing Chartered Accountant was appointed to represent a company before the tax authorities. He submitted on behalf of his clients certain information and explanations to the authorities, which were found to be false and misleading. (4 Marks)
- (d) AB & Co., a firm of Chartered Accountants, included the name of P as a partner while filing an application for empanelment as auditor for Public Sector bank branches. It was subsequently noticed that on the date of application, P was not a partner with AB & Co. (4 Marks)

### Answer

- (a) Under Section 2(2)(iv) of the Chartered Accountants Act, 1949, "A member of the Institute shall be deemed "to be in practice" when individually or in partnership with Chartered Accountants in practice, he, in consideration of remuneration received or to be received renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice. Pursuant to Section 2(2) (iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services".  
The definition of the expression "Management Consultancy and other Services" includes Personnel recruitment and selection. Personnel Recruitment and selection includes, development of human resources including designing and conduct of training programmes, work study, job description, job evaluation and evaluations of work loads. So A is not guilty of professional misconduct.

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

Thus the chartered accountants are guilty of misconduct. Distance given in the question is not relevant for deciding.

- (c) As per clause 5 of Part I of Second Schedule if a member in practice fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary to make the financial statement not misleading, where he is concerned with that financial statement in a professional capacity, he will be held guilty under clause (5). As per clause 6 of Part I of Second Schedule if he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity, he will be held guilty under clause 6.

In given case, the Chartered Accountant had submitted the statements before the taxation authorities. These statements are based on the data provided by the management of the company. Although the statements prepared were based on incorrect facts and misleading, the Chartered Accountant had only submitted them acting on the instructions of his client as his authorized representative.

Hence the Chartered Accountant would not be held liable for professional misconduct.

- (d) Under clause 3 of Part II of second schedule, a Chartered Accountant whether in practice or not is guilty of professional misconduct if he includes in any information, statement, return or form to be submitted to the Institute, Council or any of its committees, Directors (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.

In the instant case A B & Co. included another Chartered Accountant name as partner in his firm, in his application for empanelment as Auditor of branches of Public Sector Banks submitted to the Institute. In fact such a member was not a partner of the said firm on the date of application. He will be held guilty of professional misconduct.

### Question 3

- (a) "The method of collecting Audit evidence and evaluating the same changes drastically under EDP Auditing". Comment on the above. (8 Marks)
- (b) What are the features of a qualified Audit Report? (8 Marks)

### Answer

- (a) Effects of EDP Auditing: Auditor must provide a competent, independent opinion as to whether the financial statements records and report a true and fair view of the state of affairs of an entity. However, computer systems have affected how auditors need to

collect and evaluate evidence. These aspects are discussed below:

- (1) Changes to Evidence Collection - Collecting evidence on the reliability of a computer system is often more complex than collecting evidence on the reliability of a manual system. Auditors have to face a diverse and complex range of internal control technology that did not exist in manual system, like:
  - (a) accurate and complete operations of a disk drive may require a set of hardware controls not required in manual system,
  - (b) system development control include procedures for testing programs that again are not necessary in manual control.

Since, Hardware and Software develop quite rapidly, understanding the control technology is not easy. With increasing use of data communication for data transfer, research is focussed on cryptographic controls to protect the privacy of data. Unless auditors keep up with these developments, it will become difficult to evaluate the reliability of communication network competently.

The continuing and rapid development of control technology also makes it more difficult for auditors to collect evidence on the reliability of controls. Even collection of audit evidence through manual means is not possible. Hence, auditors have to run through computer system themselves if they are to collect the necessary evidence. Though generalized audit softwares are available the development of these tools cannot be relied upon due to lack of information. Often auditors are forced to compromise in some way when performing the evidence collection.

- (2) Changes to Evidence Evaluation - With increasing complexity of computer systems and control technology, it is becoming more and more difficult for the auditors to evaluate the consequences of strength and weaknesses of control mechanism for placing overall reliability on the system.

Auditors need to understand:

- (a) whether a control is functioning reliably or multi functioning,
- (b) traceability of control strength and weakness through the system. In a shared data environment a single input transaction may update multiple data item used by diverse, physically disparate user, which may be difficult to understand.

Consequence of errors in a computer system is a serious matter as errors in computer system tend to be deterministic, i.e., an erroneous program will always execute data incorrectly. Moreover, the errors are generated at high speed and the cost and effort to correct and rerun program may be high. Errors in computer program can involve extensive redesign and reprogramming. Thus, internal controls that ensure high quality computer systems should be designed implemented and operated upon. The auditors must ensure that these control are sufficient to maintain assets safeguarding, data integrity, system effectiveness and system efficiency and that they are in position and functioning.

(b) The features of a qualified report are:

1. Clarity: The Auditor must express the nature of qualification, in a clear and unambiguous manner.
2. Explanation: Where the Auditor answers any of the statutory affirmations in the negative or with a qualification his report shall state the reasons for such answer.
3. Placement: All qualifications should be contained in the Auditor's Report. When there are notes which are subject matter of a qualification, the same should preferably be annexed to the Auditors' Report. However a reference to the notes to Accounts in the Auditors' Report does not automatically become a qualification.
4. Subject to: The words 'subject to' are essential to state any qualification. The qualification should be preceded by words such as 'subject to' or 'except that' to make it clear that he is making an exception.
5. Quantification: It is also necessary that the auditor should quantify, wherever possible, the effect of individual as well as the total effect of all qualifications on profit or loss and/or state of affairs these qualifications on the financial statements in a clear and unambiguous manner. In circumstances where it is not possible to quantify the effect of the qualifications accurately the auditor may do so on the estimates made by the management after carrying out such audit tests as are possible and clearly indicate that the figures given are based on the estimates of the management.
6. Nature of qualification: Vague statements the effect of which on accounts cannot be ascertained like 'the debtors balances are subject to confirmation', 'no provision for taxation has been made in view of the loss during the year' etc., should be avoided.
7. Violation of law: Where the company has committed an irregularity resulting in a breach of law, the Auditor should bring the same to the notice of the shareholders by properly qualifying his report.
8. Notes – Report Relationship – Where notes of a qualificatory nature appear in the accounts the Auditors should state all qualifications independently in their report so that the user can assess the significance of these qualifications.
9. Draft Report: The auditor may discuss matters of qualification with the management of the company to acquire their views. It is not necessary that the Auditor should accept the managements view and modify his opinion. But it would enable the Auditor to accurately draft the qualifications in his Final Report.

#### Question 4

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

(8 Marks)

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

(8 Marks)

Answer

(a) Due Diligence review of cash flow :

- (i) Review the historical pattern of cash flows of the organization and look for change in trends.
- (ii) See whether the company is able to meet its cash requirements from internal generations/accruals or does it seek outside sources from time to time.
- (iii) Check whether the company honours its commitments to creditors, Government and other stock holders.
- (iv) Verify the ability of the company to turn its stock into Debtors i.e sale ability of its products.
- (v) Ensure that the company follows up with Debtors and that the Debtors collection period is not very large.
- (vi) Check the ability of the company to deploy its funds in profitable investment opportunities.
- (vii) Look into the investment pattern of the company, whether they give maximum benefits to the company and are easily realizable.

(b) In exercise of the powers conferred by clause (a) of sub-section (1) of section 642 of the Companies Act, 1956 (1 of 1956), read with sub-section (3C) of section 211 and sub-section (1) of section 210A of the said Act, the Central Government, in consultation with National Advisory Committee on Accounting Standards, made the Companies (Accounting Standards) Rules, 2006. As per these rules "Small and Medium Sized Company" (SMC) means, a company-

- (i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;
- (ii) which is not a bank, financial institution or an insurance company;
- (iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;
- (iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and
- (v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

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

Question 5

(a) As the Statutory Auditor of a Manufacturing Company, what are the points you will consider to conclude "Whether the company has an Internal Audit system commensurate

with the size of the company and its operations"? (8 Marks)

- (b) In a Company, it is suspected that there has been an embezzlement in cash receipts. As an investigator, what are the areas that you would verify? (8 Marks)

Answer

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

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

- (i) What is the size of the internal audit department? In considering the adequacy of internal audit staff, it is necessary to consider the nature of the business, the number of operating points, the extent to which control is decentralised, the effectiveness of other forms of internal control, etc.
- (ii) What are the qualifications of the persons who undertake the internal audit work? Internal auditing is reasonable to expect that the internal audit department should normally be headed by a chartered accountant and that, depending upon the size of the department, it employs other qualified persons.
- (iii) To whom does the internal auditor report? In general, the higher the level to which the internal auditor reports, the greater will be his independence.
- (iv) What are the areas covered by the internal audit? Internal audit can cover a large number of areas including operational auditing, organisation and methods studies, special investigations and the like.
- (v) Has the internal auditor adequate technical assistance? This can be provided either by having full-time technically qualified persons in the internal audit department or by such persons being deputed to the internal audit department for specific assignments.
- (vi) What are the reports which are submitted by the internal auditor or what other evidence is there of his work? Auditor should satisfy himself that an internal audit system is functioning effectively. He can do so by examining the reports submitted by the internal auditor.
- (vii) What is the follow-up? It is necessary that there is an adequate follow-up system to ensure that the errors pointed out are corrected and remedial action taken on the deficiencies reported upon.

- (b) The following areas need to be verified in this regard:
- (i) Issuing a receipt for full amount collected, entering only a lesser amount on the counterfoil.
  - (ii) Showing a larger cash discount than actually allowed.
  - (iii) Adjusting a fictitious credit in the account of a customer for goods returned.
  - (iv) Cash sales entered as credit sales with debit to customer.
  - (v) Writing off a good debt as bad and irrecoverable to cover up misappropriation of amount collected.
  - (vi) Short-debiting customer's ledger account and withdrawing the difference on collection of full amount.
  - (vii) Under-casting the receipts side of cash book; carrying over a shorter total of the receipts from one page of the cash book to the next so as to cover up short banking misappropriated.
  - (viii) Over-casting the payment side of the cash book; over-carrying the total of the payments from one page of the cash book to the next so as to cover up misappropriation of a part of the amount withdrawn from the bank.

#### Question 6

- (a) List the matters to be included in the 'Auditors' report' in the case of Non Banking Financial Companies (NBFCs) accepting or holding public deposits. (8 Marks)
- (b) What are the steps for the Audit under the State level 'Value Added Tax' (VAT)? (8 Marks)

#### Answer

- (a) The Auditors are required to make a separate report to the Board of Directors and the RBI for every financial year as per the Non Banking Companies Auditors' Report (RBI) Direction 1998, in addition to the reporting obligations u/s 227 of the Companies Act 1956.
- (1) Reporting Requirements: The auditor shall make –a statement on the following matters, together with reasons in case of any unfavourable or qualified statement:
- (a) Registration: Whether the NBFC has obtained certificate of Registration or applied for registration.
  - (b) Communication from RBI: Whether the NBFC has received any communication from RBI refusing grant of Certificate of Registration.
- (2) NBFCs accepting/holding public deposits:
- (i) Limit on Public Deposits: Whether the public deposits and the following borrowings are within the permissible limits
    - (a) Borrowing from public by issue of unsecured Non-convertible Debentures/Bonds.

- (b) Borrowing from its share holders by a public limited company and
  - (c) Other deposits within the definition of "Public Deposit" in the NBFC (Reserve Bank) Direction, 1998.
  - (ii) Credit Rating: Whether Credit rating for fixed Deposits, assigned by the credit rating agency is in force.
  - (iii) Limit on Fixed Deposits: Whether aggregate amount of Deposit outstanding at any point during the year has exceeded the limit specified by the Credit Rating Agency.
  - (iv) Default: Whether the NBFC has defaulted in paying to its Depositors the interest and/or principal amount of the deposits after such interest and/or principal became due.
  - (v) Prudential Norms: Whether the NBFC has complied with NBFC Prudential Norms (Reserve Bank) Direction, 1998 in relation to Income Recognition. According standards, classification, Provisioning for bad and doubtful debts and concentration of Credit/Investment.
  - (vi) Capital Adequacy: Whether the capital Adequacy Ratio disclosed in the return submitted to the RBI is correctly determined and whether such ratio is in compliance with the minimum capital to Risk Asset Ratio prescribed by the RBI.
  - (vii) Liquidity: Whether the NBFC has complied with the prescribed liquidity requirement and kept the approved securities with designated Bank.
  - (viii) Return of Deposits: Whether the NBFC has furnished the return of deposits to the RBI within the stipulated period as required under First Schedule to NBFC Prudential Norms (Reserve Bank) Directions, 1998.
- (b) VAT is a tax on the value added to the commodity at each stage in the production and distribution chain. VAT is an indirect Tax on consumption. It is a tax on the value at the retail point of sale which is collected at each stage of sale.
- The essence of VAT is that it provides credit set off for input tax i.e. tax paid on purchases against the output tax i.e. tax payable on sales.
- The following steps have to be taken by the auditors while auditing under VAT.
- (i) Knowledge of Business: The Auditor should familiarize himself with the business of the Auditee.
  - (ii) Knowledge about VAT Law and Allied Laws: The Auditor should study the VAT Law particularly definitions, procedures to be adopted, provision regarding issues of invoices, claiming of input tax credit etc.
  - (iii) Major Accounting Policies: The Auditor should ascertainable major accounting policies with regard to sales purchases and valuation of inventory.

- (iv) Accounting Records maintained by Auditee: The auditor should obtain a complete list of all the accounting records relating to sales/purchase of goods, stock, various registers ledgers etc, maintained in which, the transactions are recorded.
- (v) Evaluation of Internal control: The Auditor should evaluate the internal controls prevalent in the entity with respect to sales, Purchases, Production and Accounting. He must examine the adequacy and effectiveness of the controls in order to plan the nature and timing of his audit procedures.

The following provisions of VAT need to be understood :

- Credit for inputs/supplies (and its accounting)
- Credit in case of capital goods.
- Utilising VAT credit for set off
- Valuation of inventories/capital goods
- Credit for goods lying in stock at inception of VAT scheme.
- VAT on sales.

#### Question 7

- (a) M/s PQR & Company, Chartered Accountants have been appointed Statutory Auditors of a listed Company for the year ended 31<sup>st</sup> March, 2008. Draft an appropriate engagement letter to be sent to the Board of Directors for the same. (12 Marks)
- (b) T Pvt. Ltd.'s paid up Capital & Reserves are less than Rs. 50 lakhs and it has no outstanding loan exceeding Rs. 25 lakhs from any bank or financial institution. Its sales are Rs. 6 crores before deducting Trade discount Rs. 10 lakhs and Sales returns Rs. 95 lakhs. The services rendered by the company amounted to Rs. 10 lakhs. The company contends that reporting under Companies Auditor's Reports Order (CARO) is not applicable. Discuss. (4 Marks)

#### Answer

- (a) Draft of an Engagement Letter:

To the Board of Directors

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

We will conduct our audit in accordance with the auditing standards generally accepted in India and with the requirements of the Companies Act, 1956. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on

a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

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

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

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

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

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

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

Our fees will be billed as the work progresses.

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

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

PQR & Co.  
Chartered Accountants

.....

(Signature)  
(Name of the Member)

(Designation)

Date :

Place :

Acknowledged on behalf of  
\_\_\_\_\_ Company by

.....

(Signature)

Name and Designation

Date

- (b) Since paid up capital and reserves of T Pvt. Ltd. is less than Rs. 50 lakhs and has no loan outstanding exceeding rupees 25 lakhs from any bank or financial institution, the only other condition is whether turnover exceeds rupees five crores. Turnover is not defined in the CARO. Part II of Schedule VI defines the term "turnover" as the aggregate amount for which sales are affected by the company. "Sales affected" would include sale of goods as well as services rendered by the company.

For ascertaining turnover though trade discount and sales returns should be deducted, the inclusion of services rendered would result in a turnover of Rs. 5.05 crores (i.e. 6 - 0.10 - 0.95 + 0.10 crore) Hence CARO will apply to T. Pvt. Ltd.

#### Question 8

Write short notes on any four of the following:

- Peer review
- Supplementary Audit u/s 619(4) of the companies Act, 1956.
- Purchase method of Accounting for amalgamations.
- Accounting ratios in Form 3 CD of Tax Audit.
- Circuit Filters (as specified by SEBI)
- Situations where external confirmations can be used. (4X4 = 16 Marks)

#### Answer

- (a) Peer Review: The term "peer" means a person of similar standing. The term "review" means conduct of re-examination or retrospective evaluation of the subject matter. In

general, for a professional, the term "peer review" would mean review of work done by a professional, by another professional of similar standing. 'Peer Review' is defined as, a regulatory mechanism for monitoring the performances of professionals for maintaining quality of service expected of them for enhancing the reliance placed by the users of financial statements for economic decision-making.

As per the Statement of Peer Review (ICAI, 2002) "Peer Review" means an examination and review of the systems and procedures to determine whether they have been put in place by the practice unit for ensuring the quality of attestation services as envisaged and implied/mandated by the Technical Standards and whether these were effective or not during the period under review".

The examination and review of a practice unit would be carried out by a "reviewer", i.e., a member, selected from a panel of reviewers maintained by the Board. The term "practice unit" means members in practice, whether practising individually or as a firm of Chartered Accountants.

- (b) Supplementary Audit u/s 619(4) of the Companies Act, 1956: The auditor of a Government company shall be appointed or re-appointed by the Comptroller and Auditor-General of India . The auditor aforesaid shall submit a copy of his audit report to the Comptroller and Auditor-General of India who shall have the right to comment upon, or supplement, the audit report in such manner as he may think fit. Any such comments upon, or supplement to, the audit report shall be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.
- (c) Purchase method of Accounting for Amalgamation: Under the purchase method in preparing the transferee company's financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company. Any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve. The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortization period should not exceed five years unless a somewhat longer period can be justified. Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company. The corresponding debit should be given to a suitable account head (e.g., 'Amalgamation Adjustment Account') which should be disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be

maintained, both the reserves and the aforesaid account should be reversed.

(d) Accounting Ratios in Form 3CD of Tax Audit:

- (i) Gross Profit/Turnover
- (ii) Net Profit/Turnover
- (iii) Stock in Trade/Turnover
- (iv) Material consumed/finished goods produced.

These ratios have to be calculated only for assessees who are engaged in manufacturing or trading activities. This clause is not applicable to assessees carrying on profession. Moreover, the ratios have to be given for the business as a whole and need not be given product wise. Further, the ratio mentioned in sub-clause (d) need not be given for trading concern.

(e) Circuit Filters: Circuit breakers or filters are the price bands that set the upper and lower limit within which a stock can fluctuate on any particular day. A price band for a day is a function of previous trading days' closing. SEBI has directed exchanges to apply circuit filters on scrips traded in rolling settlement if their price fluctuates more than 20% of the closing price of scrips on the previous day in any direction. However for scrips forming part of sensex or in which derivatives and futures are available, the fluctuation is restricted to 10%.

(f) Situations where external confirmations can be used: (Refer AAS 30)

- (i) Bank balance from bankers
- (ii) Account receivable balances
- (iii) Stocks held by third parties
- (iv) Property title deeds held by third parties
- (v) Investments purchased but delivery not taken
- (vi) Loan from lenders
- (vii) Account payable balances
- (viii) Long outstanding share application money.