Gurukripa's Guideline Answers to Nov 2013 Exam Questions
CA Final ADVANCED AUDITING AND PROFESSIONAL ETHICS

Question No.1 is compulsory **(4 X 5 = 20 Marks).**
Answer **any five** questions from the **remaining six** questions **(16 X 5 = 80 Marks).** [Answer any 4 out of 5 in Q.7]

Question 1(a): AS – 11 – Special Provision for Companies (5 Marks)

X Limited, a newly incorporated Company in India commenced its business from 1st April 2012. The Company purchased Fixed Assets costing ₹ 4,000 Lakhs on 01–04–2012 and the same was fully financed by Foreign Currency Loan (U.S. Dollars) payable in three annual equal installments. Exchange Rates were 1 Dollar = ₹ 40.00 and ₹ 42.50 as on 01–04–2012 and 31–03–2013 respectively. The Company worked out Foreign Exchange Loss as per AS 11 at ₹ 250 Lakhs and expensed the entire amount in the Profit and Loss Account. The Managing Director of the Company was worried about this heavy revenue loss and asked the Accountant not to follow AS 11 issued by the ICAI for this particular transaction. The Accountant of the Company, followed the instruction of the Managing Director and removed Exchange Loss from the Profit and Loss Account but then he added the entire Exchange Loss to the value of Fixed Asset and computed the depreciation thereon. As an Auditor of X Limited how you would you deal with this particular transaction?

Solution: Refer Padhuka's Students' Referencer on Accounting Standards – Page No. 11.24

1. **Treatment as per AS:** As per AS – 11, Foreign Exchange Loss on repayment of a debt in relation to acquisition of a Fixed Asset shall be written off in the Statement of Profit and Loss. It cannot be capitalized and amortised over the period of the asset.
2. **Special Relaxation to Corporates:**
   (a) As per MCA Notification dated 29th Dec. 2011, Companies are given an option to capitalize the above costs and claim depreciation thereon. This Notification is applicable for accounting year upto 31st March 2020.
   (b) The option exercised by the Enterprise shall disclose the fact of such option, and the amount remaining to be amortised in the Financial Statements of the period in which such option is exercised, and in every subsequent period so long as any exchange difference remains unamortised.
3. **Conclusion:** If the above option is exercised by the Company, then the fact that it is exercised shall be disclosed in the Notes on Accounts. In such case, the Auditor can issue a Clean Opinion on the Financial Statements.

Question 1(b): SA – 402 Entities using Service Organisations (5 Marks)

G Ltd is a Mobile Phone operating Company. Barring the marketing function, it had outsourced the entire operations like Maintenance of Mobile Infrastructure, Customer Billing, Payroll, Accounting Functions, etc. Assist the Auditor of G Ltd as to how he can obtain an understanding of how G Ltd uses the services of the Outsourced Agency in its operations.

Solution: Refer Padhuka's Students' Referencer on Standards on Auditing – Page No. 75, Para A.7, Para A.8.

Under–standing how services are used [Para 9, A.7]	When obtaining an understanding of the User Entity, the User Auditor shall obtain an understanding of how a User Entity **uses the services** of a Service Organisation in the User Entity's operations, including, – (a) Nature of the services provided by the Service Organisation and the significance of those services to the User Entity, including the effect thereof on the User Entity's internal control, (b) Nature and materiality of the transactions processed or accounts or financial reporting processes affected by the Service Organisation, (c) Degree of interaction between the activities of the Service Organisation and those of the User Entity, i.e, the extent to which a User Entity is able to implement effective controls over the processing performed by the Service Organisation and (d) Nature of the relationship between the User Entity and the Service Organisation, including the relevant contractual terms for the activities undertaken by the Service Organisation.
Sources of Information [Para A.1, A.2 & A.8]	Information on the nature of services provided by a Service Organisation may be available from– (a) User Manuals, System Overviews, Technical Manuals. (b) Contract or Service Level Agreement between the User Entity & the Service Organisation (c) Reports by Service Organisation, Internal Auditors or Regulatory Authorities, on controls at the Service Organisation, Reports by the Service Auditor, including Management Letters, if available. (d) Knowledge obtained through the User Auditor's experience with the Service Organisation.

Question 1(c): Audit of Consolidated Financial Statements – Reporting Requirements (5 Marks)

Beta Limited is a Company registered with SEBI, having five Subsidiaries. M/s XYZ, Chartered Accountants, have been appointed a Statutory Auditors for the audit of the Consolidated Financial Statements for the year ending 31st March 2013. Out of five Subsidiaries, the Audit of one Subsidiary was conducted by another Auditor, M/s Badnam and Company, Chartered Accountants. The "Opinion" para of Audit Report furnished by M/s XYZ Chartered Accountants is given below –

Opinion

In our opinion and to the best of our information and according to the explanations given to us the Consolidated Financial Statements give a true and fair view, except the Financial Statement of one Subsidiary whose accounts were audited by M/s Badnam and Company, Chartered Accountants and about the same we are not in a positions to express our opinion as the Audit has not been performed by us:

(i) In the case of the Consolidated Balance Sheet, of the state of affairs of the Company as at March 31, 2013.

(ii) In the case of the Consolidated Profit and Loss Account, of the Profit/Loss for the year ended on that date.

Do you find any deficiencies in the Opinion Para? If yes, you are required to give your suggestions & redraft the Opinion Para.

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 13.7, Q.No.13

1. **Special Duties** when Parent Auditor is **not** the Auditor of One / More Components:
   (a) The Auditor of the CFS should also consider the requirement of SA–600 Using the Work of Another Auditor.
   (b) When the Parent's Auditor decides that he will make reference to the audit of the Other Auditors, the Auditor's report on CFS should disclose clearly the **magnitude** of the portion of the Financial Statements audited by the Other Auditor(s).
   (c) This may be done by stating the Rupee Amounts or Percentages of Total Assets and Total Revenue of Subsidiary(s) included in CFS not audited by the Parent's Auditor.
   (d) However, reference in the CFS Auditor's Report to the fact that part of the audit of the Group was made by other Auditor(s), is **not** to be construed as a qualification of the opinion, but rather as an indication of the divided responsibility between the Auditors of the Parent and its Subsidiaries.

2. **Deficiencies in the Opinion Para given in the Question:**
   (a) Exception of one Subsidiary's Financial Statement cannot be made. SA – 600 should be applied.
   (b) Reference to Consolidated Cash Flow Statement is not given in the above Para.

3. **Redrafted Opinion Para:**

Opinion

In our opinion and to the best of our information and according to the explanations given to us, and based on consideration of the reports of the other Auditors on the Financial Statements / Consolidated Financial Statements of the Subsidiaries and Associates as noted below, the Consolidated Financial Statements give a true and fair view in conformity with the accounting principles generally accepted in India –

(a) in the case of the Consolidated Balance Sheet, of the State of Affairs of the Group as at March 31, 2013,

(b) in the case of the Consolidated Statement of Profit and Loss, of the Profit / (Loss) of the Group for the year ended on that date, and

(c) in the case of the Consolidated Cash Flow Statement, of the Cash Flows of the Group for the year ended on that date.

Other Matters

1. Financial Statements of certain Subsidiaries which reflect Total Assets (net) of ₹ ...... Crore as at March 31, 2013, Total Revenues (net) of ₹ ...... Crores, and Net Cash Flows amounting to ₹ ..... Crores for the year then ended, have been audited by us.
2. We have not audited the Financial Statements of certain Subsidiaries, whose Financial Statements reflect Total Assets (net) of ₹ ..... Crores as at March 31, 2013, Total Revenues (net) of ₹ ..... Crore, and Net Cash Flows amounting to ₹ ..... Crore, for the year ended on that date. These Financial Statements have been audited by Other Auditors whose reports have been furnished to us, and our opinion is based solely on the reports of the Other Auditors.

Our Opinion is not qualified in respect of Other Matters specified above.

Question 1(d): Year–End Transactions – Audit Evidence – Audit Approach (5 Marks)

M/s Honest Limited has entered into a transaction on 5th March 2013, near year–end, whereby it has agreed to pay ₹ 5 Lakhs per month to Mr. Y as annual retainership fee for "Engineering Consultation". No amount was actually paid, but ₹ 60 Lakhs is provided in Books of Account as on 31st March 2013.

Your inquiry elicits a response that need–based consultation was obtained round the year, but there is no documentary or other evidence of receipt of the service. As the Auditor of M/s Honest Limited, what would be your approach?

Solution: Refer Padhuka's Students' Referencer on Standards on Auditing – Page No. 84

1. **Audit Procedures:** In the present case, the Company has entered into the agreement only on 5th March 2013. However a provision has been created for the entire year. Hence the following points are to be verified:
   (a) Ascertain the **nature of consultation received** during the year (in the form of Consultancy Reports, Certificates, etc.) to ascertain whether the transaction is genuine.
   (b) Obtain **Management Representation** in respect of the consultation taken.
   (c) Obtain **External Confirmation** from Mr. Y for the nature of consultations rendered and the amount receivable from the Company during the year.
   (d) Check whether the Consultation Fee provided by the Company is at **arms–length price**, having regard to the nature of consultation. **Expert Opinion** can be obtained in this regard.
   (e) Check whether Mr.Y is a **Related Party**, and if so apply audit procedures to comply with SA – 550.
   (f) Perform **Analytical Review** procedures by comparing the amount of expenditure incurred in previous periods if applicable.
   (g) Examine compliance with AS – 29 for **recognition of a Provision** with respect to the conditions – (i) Present Obligation out of a Past Event, (ii) Probable Outflow of Resources, and (iii) Reliable Estimate of the amount.

2. **Conclusion:** Based on SA – 500, the Auditors' Approach should be as under –

Situation	The Auditor shall –
(a) Audit Evidence obtained from one source is **inconsistent** with that obtained from another, or (b) Auditor has **doubts over the reliability** of information to be used as audit evidence,	• Determine what modifications or additions to audit procedures are necessary to **resolve the matter**, and • Consider the **effect of the matter**, if any, on other aspects of the audit.

Question 2(a): Professional Ethics (4 Marks)

Mr. X who passed his CA Examination of ICAI on 18th July 2013, and started his practice from 15th August 2013. On 16th August 2013, one female candidate approached him for articleship. In addition to monthly stipend, Mr. X also offered her 1% Profits of his CA Firm. She agreed to take both 1% Profits of the CA Firm and Stipend as per the rate prescribed by the ICAI. The Institute of Chartered Accountants of India sent a letter to Mr. X objecting the payment of 1% Profits. Mr. X replies to the ICAI stating that he is paying 1% Profits of his Firm over and above the Stipend to help the Articled Clerk as the financial position of the Articled Clerk is very weak. Is Mr. X liable to professional misconduct?

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 20.13, Q.No. 31

1. **Eligibility to Train Students:** A Member (ACA or FCA) who is in continuous practice for a period upto 3 years / employed under another CA for a period upto 3 years is eligible to train One Articled Assistant. Hence Mr. X is eligible to train 1 Assistant.

2. **Share of Profits of Firm – as Additional Stipend:** This constitutes Professional Misconduct under –

Reference	Nature of Misconduct
Schedule I, Part I, Clause 2	Pays or allows or agrees to pay or allow, directly or indirectly, any Share, Commission or Brokerage in the Fees or Profits of his professional business, to any person other than – (a) a Member of the Institute, or (b) a Partner, or (c) a Retired Partner, or (d) the legal representative of a Deceased Partner, or (e) a Member of any other professional body, or (f) with such other persons having such qualifications as may be prescribed, for the purpose of rendering such professional services from time to time in or outside India. **Note:** "Partner" includes a person residing outside India, with whom a CA in practice has entered into Partnership which is not in contravention of Clause (4) below.

Note: Weak Financial Position of Articled Clerk, etc. do not absolve the CA of misconduct in this case.

Question 2(b): Professional Ethics (4 Marks)

Mr. Honest, a Chartered Accountant in practice, wrote two letters to M/s XY Chartered Accountants a Firm of CAs, requesting them to allot him some professional work. As he did not have a significant practice or Clients, he also wrote a letter to M/s ABC, a Firm of Chartered Accountants for securing professional work. Mr. Clever, another CA, informed ICAI regarding Mr.Honest's approach to secure the professional work. Is Mr. Honest wrong in soliciting professional work?

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 20.17, Q.No. 39

1. **Principle:**
   (a) Under Clause (6) of Part I of First Schedule, a CA 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) Nothing in Clause (6) shall be construed as preventing or prohibiting –
      (i) any CA from applying or requesting for or inviting or securing professional work from another CA in practice, or
      (ii) a Member from responding to tenders or enquiries issued by various users of professional services or organization from time to time and securing professional work as a consequence.
2. **Conclusion:** In the above case, the CA is not guilty of Professional misconduct.

Question 2(c): SRS – 4410 – Compilation of Financial Statements (4 Marks)

C & Co, hired Mr. A, Chartered Accountant, to compile its Financial Statements for the interim period ending on 31st December 2012. Kindly assist Mr. A in drafting scope of Engagement Letter with specific focus on C & Co's responsibility.

Solution: Refer Padhuka's Students' Referencer on Standards on Auditing – SRS 4410, Page No. 257

The following **draft Engagement Letter** may be adopted by the Accountant engaged to compile financial information –

Date:

To the Board of Directors (or other appropriate representatives of senior Management) of C & Co.

You have, vide your letter dated ________ requested that we compile the Balance Sheet of C & Co. as at 31st Dec 2012, 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 understanding of the engagement by means of this letter. As no Audit or Review Engagement procedures would be carried out, no opinion on the Financial Statements will be expressed. Further, our engagement cannot be relied upon to disclose whether frauds or defalcations, or illegal acts exist. However, we will inform you of any such matters which might come to our attention in the course of the engagement. As Management, you are responsible for,

(a) Accuracy and completeness of the information supplied to us, including maintenance of adequate accounting records and internal controls and selection and application of appropriate accounting policies.
(b) Preparation and presentation of the Financial Statements of the entity, in accordance with the applicable laws and regulations, if any.
(c) Safeguarding the Assets of the entity and also establishing appropriate controls designed to prevent and detect fraud and other irregularities.
(d) Ensuring that the activities of the entity are carried in accordance with applicable laws and regulations and that it institutes appropriate controls to prevent and detect any non-compliance.

You will confirm that events and transactions are recorded in accordance with the applicable Accounting Standards, issued by the Institute of Chartered Accountants of India and other recognised accounting principles and practices and inform us of any departures therefrom.

As part of our normal procedures, we may request you to provide Written Confirmations of any information or explanations given to us orally during the course of our work. We understand that the intended use and distribution of the information we have compiled is _________________ *(to be specified).* We look forward to full co–operation with your staff and we trust that they will make available to us whatever records, documentation and other information requested in connection with our engagement. Our fees will be billed as the work progresses. 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 compilation of your Financial Statements.

…………………………..

Signature
Mr.A, Chartered Accountant
Address and Date.

Acknowledged on behalf of C & Co.

Signature
Name and Designation
Date
Address

Question 2(d): SA 320 – Materiality (4 Marks)

Mr. X was appointed as the Auditor of M/s Easygo Ltd and intends to apply the concept of materiality for the Financial Statements as a whole. Please guide him as to the factors that may affect the identification of an appropriate benchmark for this purpose.

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 23.17, Point B (2), and Padhuka's Students' Referencer on Standards on Auditing – SA 320, Page No. 65, Point B (2)

Factors: Factors that may affect the identification of an appropriate benchmark in this regard include –

1. Elements of the Financial Statements (e.g. Assets, Liabilities, Equity, Revenue, Expenses),
2. Whether there are items on which the attention of the users of the particular Entity's Financial Statements tends to be focused (e.g. Profit, Revenue or Net Assets),
3. Nature of the Entity, where the Entity is at in its life cycle, and the industry and economic environment in which the Entity operates,
4. Ownership Structure and Financing Pattern (e.g. if an Entity is financed more by Debt rather than Equity, Users may put more emphasis on Assets, and claims on them, than on the Entity's Earnings), and
5. The relative volatility of the benchmark.

Question 3(a): AS – 15 Employee Benefits (4 Marks)

Excellent Limited, a Company incorporated in India and listed with SEBI, has a scheme for payment of Settlement Allowance to Retiring Employees. Under the Scheme, retiring employees are entitled to reimbursement of certain travel expenses for class they are entitled to as per Company Rules and Regulations. Employees are also entitled to claim a lump–sum payment to cover expenses on food and stay during the travel. The Company also gives option to Employees that they can claim a lump–sum amount equal to three months pay last drawn.

Excellent Limited have following accounting policies to record these travel expenses –

(i) Settlement Allowance does not depend upon the length of service of employee. It is restricted to Employee's eligibility under the travel rules of the Company. Therefore, all travel expenses fall under the category of Defined Contribution Plans.

(ii) Since it is not related to the length of service of the employees, it is difficult to estimate reliably and there is no present obligation to pay Employees as per AS 29 "Provisions, Contingent Liabilities and Contingent Assets", hence it is accounted for on claim basis.

You are the Statutory Auditor of Excellent Limited. What would be your guidance to audit team?

Solution: Refer Padhuka's Students' Referencer on Accounting Standards –Page No. 15.11, Q.No. 26 Similar to F (A/cs) – N 08 Question

1. **Nature of Benefit:**
   (a) **Post Employment Benefit:** Settlement Allowance to Retiring Employees and Reimbursement of Travel Charges, etc. is paid **after** completion of the period of employment. Hence, such payment is in the nature of Post–Employment Benefits.
   (b) **Defined Benefit Plan:** Though the nature of benefits is identified, the Employer does **not** earmark a fixed sum for such scheme. Therefore, it is in the nature of Defined Benefit Plan.

2. **Accounting:** Under AS–15, Defined Benefit Plans should be accounted in the following manner –
   (a) Use of Actuarial Methods to make a reliable estimate of the future obligations.

(b) Determine the PV of such obligation using a proper discount rate (based on return on Government Bonds).

(c) Reduce the Plan Assets (if any) from the above, to determine the actual liability.

3. **Evaluation of Company's Contention:**

(a) The Company's contentions are not correct since, the benefits under consideration are covered by "Defined Benefit Plan" and are in the nature of Post Employment Benefits under AS–15.

(b) These benefits results to an Employee for being in employment. These are made towards services provided by such employees during the course of employment. Therefore, cost of these benefits should also be accounted for in the period during which such services are rendered.

(c) The fact that such benefits are not dependent upon length of service, has no relevance to its accounting, as cost (both present, as well as future) should be recognized as and when incurred, and its benefit received.

Question 3(b): Audit in CIS Environment (4 Marks)

Q Ltd operates in an ERP environment. Its Auditor requires your assistance on the aspects that are needed to be looked into in respect of control over input and output of transactions. Kindly help him.

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 14.18, 14.19, Q.No. 28 & 30.

A.Control over Input – Verification Aspects:

1. Verify whether **pre–printed forms** are used, i.e. standard information and instruction for filing should be printed on a source document.
2. Examine the **use of Check Digit** Control, i.e. A Check Digit is a redundant digit(s) added to a code that enables the accuracy of other characters in the code to be checked.
3. Evaluate the impact of **completeness totals** and checks. The purpose of this control is to ensure that no data is left out completely from being entered into the system. Some examples are – (a) Batch Control Totals, (b) Batch Hash Totals, (c) Batch Record Totals, and (d) Sequence Checks.
4. See whether any **reasonableness checks** are employed for data validation.
5. Analyse the impact of various **Field Checks**, viz. –(a) Missing Data / Blank, (b) Alphabetic / Numeric, (c) Range, (d) Master Reference, (e) Size, and (f) Format.
6. Analyse the impact of various **Record Checks**, viz. –(a) Reasonableness, (b) Valid–Sign–Numeric, (c) Size, and (d) File Checks.

B.Control over Output – Verification Aspects:

1. See **whether the computer is programmed** to write page numbers, descriptive caption and processing dates on all printouts.
2. Ensure that the **printout contains sufficient information** to trace its source document and see whether printout figures are verifiable for calculations.
3. Check whether details and totals in the printout are **checked manually** with controls established prior to processing or from intermediate printout.
4. Verify the **existence of necessary programme** controls to ensure the completeness and accuracy of printout data.
5. Check the **procedure for investigating** and taking action on exception reports and recording the action taken.
6. **Assess physical and other controls** to ensure that all the printouts are received, recorded, reviewed and sent to the User Department in time.
7. Review whether **the system ensures that the User Department receives the printouts intact**. See whether there is any possibility of manipulation of output reports.
8. Ascertain the **User Department's experience** as regards the printouts with reference to accuracy, timeliness, format geared to User Department's needs, etc.

Question 3(c): SA 520 – Analytical Procedures (4 Marks)

In the audit of Hotel Great Stay Ltd, its Auditor wants to use the analytical procedure as substantive procedure in respect of room rental income as well as payroll costs. Guide him as to how it can be done.

Solution: **Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 23.26, Point 1**

Analytical Review on Room Rental Income	Analytical Review on Payroll Costs
1. Compare the Current year Room Rental Income with previous year Income, i.e. **Trend Analysis**. 2. Compare the Room rental income with Competitor's Income, i.e. **Inter Firm Comparison**. 3. Compare the Budgeted Room Rentals with Actual Room Rental Income, i.e. **Budget Review.** 4. Compare **REVPAR** (Revenue from Average Rack Rate) of Current Year with Previous year [REVPAR = Total Room Rent Income ÷ (No of Rooms x 365 days)]	1. Compare the Current Year Salary Costs with previous year expense, i.e. **Trend Analysis.** 2. Compare the Payroll costs with Competitor's level of expenses, i.e. **Inter Firm Comparison**. 3. Compare the budgeted Payroll Costs with Actual costs incurred, i.e. **Budget Review.** 4. Compare Payroll Cost per Employee of the current year with previous year [Payroll Cost per Employee = Salary Expense ÷ No of Employees].

Question 3(d): Professional Ethics (4 Marks)

C.A Prabhu, is a leading Income Tax Practitioner and Consultant for Derivative Products. He resides in Mumbai near to the ABC Commodity Stock Exchange and does trading in Commodity Derivatives. Every day, he invests nearly 50% of his time to settle the commodity transactions. Is C.A. Prabhu liable for professional misconduct?

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 20.2, Q.No.2,3

1. **Meaning of "to be in Practice":**
   (a) Practice includes "Management Consultancy Services", which inter–alia includes **Investment Counselling** in respect of Securities [as defined in Securities Contracts (Regulation) Act, 1956] and other Financial Instruments. Derivative Products is one of the "Securities" specified under SCRA.
   (b) A CA in practice is **not** permitted to do – (a) Broking, (b) Underwriting, and (c) Portfolio Management.
2. **Consultant for Derivative Products:** If the consultation in respect of Derivative Products **includes** management of Clients' Assets Portfolio also, CA Prabhu, being in practice, cannot be engaged in such activity.
3. **Trading in Derivatives**:
   (a) Trading in Derivatives shall be considered as a **separate business** of the Chartered Accountant.
   (b) If a CA holds Certificate of Practice, then for conducting Derivative Trading, special permission from the ICAI is required under Clause 11 of Part I of First Schedule, since this is not covered in General Permission category.
   (c) If a Member does not hold Certificate of Practice, then he is free to do trading in Derivative Transactions.

Question 4(a): AS – 23 Accounting for Investment in Associates (4 Marks)

H Limited, a Company registered with SEBI, has three Subsidiaries and one Associate. While doing the audit of Consolidated Financial Statements (CFS) of H Limited you have come to know that the Associate Entity had made a Provision for Proposed Dividend in its Financial Statements. H Limited computed it share of the results of operations of the Associate after taking into account the Proposed Dividend. Comment

Solution: Refer Padhuka's Students' Referencer on Accounting Standards – AS 23 [ASI 16], Page No. 23.4, Q.No. 9, Point 6.

1. **Principle:** Carrying Amount of Investment is reduced by the distributions (Dividends received) from Associates. However, when the Associate has made a Provision for Proposed Dividend in its Financial Statements, the Investor's Share from the Associate should be computed **without** taking into consideration the Proposed Dividend.
2. **Conclusion:** In the above case, the Accounting Treatment given by the Company is not proper**.**

Question 4(b): Bank Audit (4 Marks)

While doing the audit of a nationalized bank, your Audit Assistant informed you that there are a lot of irregularities in Telegraphic Transfers and Demand Drafts. What guidance would be give to the Audit Assistant?

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 8.7, Q.No. 9, Point H.

1. The Bank should have a **reliable Private Code** for TTs / DDs, which should be known only to the Responsible Officers of its Branches. Coding / decoding of TTs should be done only by such Officers.
2. A Responsible Officer should **verify the signatures** on the Demand Draft with the Signature Book.

3. All TTs / DDs sold / issued by a Branch should be immediately **confirmed by an advice** to the concerned Paying Branches.
4. If the Paying Branch does not receive proper confirmation of any TT / DD from the Issuing Branch or does not receive credit in its account with that Branch, then immediate steps should be taken to ascertain the reasons therefor, or it should be **informed to the Head Office** immediately.

Question 4(c): Insurance Companies Audit (4 Marks)

ABC Limited, an Indian Insurance Company carrying on General Insurance Business, is facing liquidity problems and, therefore, it has decided to maintain deposits under Section 7 of the Insurance Act, 1938 at 1% of Total Gross Premium written in India. The Company thinks that it is sufficient, as the Company has a Paid–up Capital of ₹ 150 Crores. As an Auditor of ABC Limited what would be your suggestion to the Company for compliance of Insurance Act and Rules and Regulations made there under?

1. **Deposits [Sec.7]:** Every Insurer shall, in respect of the Insurance Business carried on by him in India, deposit and keep deposited with the RBI (in any of the RBI Offices in India) **for and on behalf of the Central Government,** the amounts specified as below –

Nature of Insurance	Computation of Deposit Amount	Maximum Deposit
Life Insurance Business	1% of Total Gross Premium written **direct** in India in any financial year	₹ 10 Crores
General Insurance Business	3% of Total Gross Premium written in India in any financial year.	₹ 10 Crores
Re–Insurance Business	₹ 20 Crores	Not Applicable, since the amount is specified.
Marine Insurance only and relates exclusively to country craft or its cargo or both	₹ 1 Lakh	Not Applicable, since the amount is specified.

Note:

- The above Deposit shall be kept in Cash and / or in Approved Securities (estimated at their Market Value on the day of deposit).
- The above Deposit cannot be made subject to assignment or charge, not subject to attachment, except in certain specified situations.
- The refund of above Deposit is governed by Sec.9, when the Insurance Business is closed, and all Liabilities have been settled.
- The Insurer cannot be registered for any class of Insurance Business, unless the entire amount of Deposit u/s 7 has been made by the Insurer.

2. **Analysis and Conclusion:** In the given case, the Company is required to maintain Deposit at 3% (and not 1%) u/s 7. The availability of adequate Paid Up Capital is **not** relevant in this connection. Non–compliance with this condition may lead to questionability of Going Concern Assumption, since the Insurance Act, Rules and Regulations are not complied with by the Insurer.

Question 4(d): Auditing Preliminaries (4 Marks)

The Auditor of S Limited has just commenced the statutory audit. What should be considerations for the effectiveness of system of Internal Check?

Solution: **Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 1.6, Q.No. 15.**

The general considerations in framing a system of Internal Check are –

1. **Different Hands:** No single person should have an independent control over any important aspect of the business. All dealings and acts of every employee should, in the ordinary course, come under the review of another.
2. **Job Rotation:** The duties of staff members should be changed from time to time without any previous notice. The same officer or sub–ordinate should not, without a break, perform the same function for a considerable period of time.
3. **Leave:** Every member of the staff should be encouraged to go on leave at least once in a year. Frauds successfully concealed by employees are often unearthed when they are on leave.
4. **Assets – Books Differentiation:** Persons having physical custody of assets should not be permitted to have access to the books of account.

5. **Asset Verification:** There should be an accounting control in respect of each important class of assets. They should be periodically inspected so as to establish their physical existence.
6. **Mechanical devices:** Mechanical devices such as automatic cash register may be employed, to prevent loss or misappropriation of cash.
7. **Stock Taking:** During year–end stock–taking, trading activities should, preferably, be suspended. Stock–taking and evaluation should not be done exclusively by the Stores Staff. Employees from other departments and sections should be employed for this task.
8. **Delegation of Powers:** Financial and administrative powers, e.g. signing of cheques, verification of assets, etc. should be distributed very judiciously among different officers and the manner in which these are actually exercised should be reviewed periodically.
9. **Review of accounts:** Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.
10. **Review of Procedures:** Accounting procedures should be periodically reviewed since even well designed and carefully installed procedures may become ineffective and redundant in due course.

Question 5(a): AS – 26 Intangible Assets (4 Marks)

X Ltd is engaged in the business of Newspaper and Radio Broadcasting. It operates through different brand names. During Financial Year 2012–2013, it incurred substantial amounts on external trade, business communication and branding expenses by participation in various Corporate Social Responsibility initiatives. The Company expects to benefit by this expenditure by attracting new customers over a period of time and accordingly it has capitalized the same under Brand Development Expenses and intends to amortize the same over the period in which it expects the benefits to flow. As the Statutory Auditor of the Company, do you concur? Give reasons.

Solution: Refer Padhuka's Students' Referencer on Accounting Standards – AS 26, Page No. 26.4, Q.No.11.

1. **Principle:** Expenditure on Advertising constitutes one of the items to which AS – 26 is applicable. Recognition Criteria for Intangible Assets are –
   (a) it is probable that the future economic benefits that are attributable to the Asset will flow to the enterprise, and
   (b) the cost of the asset can be measured reliably.
2. **Conclusion:** Since the recognition criteria are met in the above case, the Company should treat the Advertising Expenditure as an "Intangible Asset". Hence, the accounting treatment given by the Company is correct.

Question 5(b): Investigation (4 Marks)

M Limited is going to acquire S Limited. The purchase consideration has been decided at ₹ 4000 Crores. M Limited is worried about hidden liabilities or overvalued assets of S Limited and approached you to examine the same. List out eight important transactions/items which you would like to investigate in the Due Diligence exercise.

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 16.24, Q.No. 41.

Hidden Liabilities	Over Valued Assets
1. Concealment of Show Cause Notices that have not matured into demands, as Contingent Liabilities. 2. Non–disclosure of Letters of Comfort to Banks and Financial Institutions. 3. Non–disclosure of sale of some Subsidiaries / Business Undertakings. 4. Product and other liability claims, warranty liabilities, product returns / discounts, liquidated damages, litigations. 5. Direct and Indirect Tax Liabilities. 6. Pending Assessments of Sales Tax, Excise & Customs Duty. 7. Buy–back agreements, future lease liabilities. 8. Environmental problems, third party claims. 9. Unfunded gratuity, superannuation benefits. 10. Unresolved labour litigations and negotiations.	1. Uncollected / uncollectible receivables. 2. Obsolete & slow moving inventories, inventories valued above NRV. 3. Underused or obsolete Plant and Machinery, spares, impairment of asset values due to fall in market value. 4. Assets carried at higher than market value, capitalisation of revenue expenditure, foreign exchange fluctuations, etc. 5. Assets and Property under litigation. 6. Investments carried at cost where realisable value is less, and those having a very low rate of return. 7. Infructuous Project Expenditure, Deferred Revenue Expenditure, Reconciliation of group Company balances, Intangible Assets having no value, etc.

Question 5(c): (4 Marks)

Mr. X, a young Chartered Accountant, wants to start practice and he requires your advice, among other things, on Criminal Liabilities of an Auditor under the Companies Act,1956. Kindly guide him.

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 19.11, Q.No.14

The circumstances in which an Auditor may be prosecuted under the Companies Act are –

1. **Misstatement in Prospectus [Sec.63]:** An Auditor is criminally liable for making any misstatement / untrue statement in a prospectus and can be sentenced to a term of imprisonment extending to two years or a fine amounting to ₹ 50,000 or to both. The Auditor may be able to avoid this liability if he proves that –
   (a) The untrue statement complained of is **immaterial**.
   (b) He had **reasonable ground to believe**, and in fact he did believe up to the time of issue of the Prospectus, that the statement was true.
   (c) He had **not authorized** the issuance of the Prospectus.

2. **Fraud and Deception [Sec. 539]:** An Auditor may be held liable if, with an intent to defraud or deceive any person –
   (a) he has destroyed, mutilated, altered, falsified, secreted any books, papers or securities of a Company or is privy to the aforesaid acts, or
   (b) he has made or is privy to the making of any false or fraudulent entry in any register, books or account or document belonging to the Company.
   (c) The proceedings can be taken in respect of a Company under winding up and the punishment may extend upto imprisonment for 7 years and / or fine. For Companies which are not being wound up, similar provisions are available u/s 477A of the Indian Penal Code.

A penal enactment under a special Act like Companies Act is no bar to a prosecution under the Indian Penal Code.	**Emperor vs Bishan Sahai Vidyarthi & Others**
Making of false entries in a book or register with the intent to conceal a fraudulent or dishonest act, also falls within the purview of Sec. 539, in as much as the intention is to defraud.	**In re: Rash Behari Das**

3. **Offences u/s 545:** An Auditor may be liable to be prosecuted u/s 545, if he, as a past or present Auditor, has been guilty of offence in relation to the Company.

4. **False Statement, etc. [Sec.628]:** The Auditor is liable to criminal prosecution if he, in any Return, Certificate, Balance Sheet, Prospectus, Statement or other document makes a statement – (a) which is false in any material particular, knowing it to be false, or (b) which omits any material facts knowing it to be material. He is punishable with imprisonment upto 2 years and also with fine. This is applicable only to false statements, which are not specifically punishable under any other section of the Act.

Question 5(d): Audit Reporting Requirements (4 Marks)

X Ltd closed its manufacturing operations and sold all its manufacturing Fixed Assets during the financial year ended 31st March 2013. However, it intends continue its operations as a Trading Company. In respect of other Fixed Assets, the Company carried out a physical verification as at the end 31st March 2013, and found a material discrepancy to the tune of ₹ 1 Lakh, which was written off an is disclosed separately in the Profit and Loss Account. Kindly incorporate the above in your Audit Report.

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No.5.8, Q.No.15

In Main Audit Report – Emphasis of Matter Para:

With reference to Note ..... to the Financial Statements on "Segment Information", we wish to state that during the current year, the Company has disposed the entire assets pertaining to its Manufacturing Activities. The Company is continuing with the business of Trading Activities and the Going Concern Assumption is not violated due to the above mentioned actions. Our opinion is not qualified in this regard.

In Annexure to Audit Report [CARO] – Fixed Assets:

(a) Proper records have been maintained to show full particulars including quantitative details and details about situation of Fixed Assets.

(b) The Management of the Company has physically verified the Fixed Assets, at reasonable intervals.

(c) During physical verification, material discrepancy to the extent of ₹ 1 lakh has been identified, and has been written off and disclosed separately in the Statement of Profit and Loss.

(d) **Going Concern:** Even though all the manufacturing Fixed Assets of the Company are disposed off during the current year, the Going Concern Assumption is not violated, since the Company intends to continue its operations as a Trading Company.

Question 6(a): Audit Evidence – Special Audit (4 Marks)

M Ltd intends to intensify its Advertisement Strategy of hoarding advertisements to increase its sale during the impending festival season. You have been appointed as the Special Auditor to examine the expenditure under this head. What will be usual evidence you will look for in this case to justify the expenditure?

Solution: Evidences / Aspects to be considered / evaluated in examination of Hoarding Advertisements are –

1. Authorization in Budgets by review of Budget Committee Minutes.
2. Contract with the Advertisement Agency.
3. Discounts applicable for various types of advertisements, conditions therefor, and its compliance by the entity.
4. Statements of Account from the Agency and computation of amount.
5. Photographs of Hoarding Advertisements, and
6. Approval from Statutory Authorities wherever applicable.

Question 6(b): Professional Ethics (4 Marks)

Mr. Nigal, a Chartered Accountant in practice, delivered a speech in the National Conference organized by the Ministry of Textiles. While delivering the speech, he told to the audience that he is a Management Expert and his Firm provides services of taxation and audit at reasonable rates. He also requested the audience to approach his Firm of Chartered Accountants of these services and at the request of audience he also distributed his business cards and telephone number of his Firm to those in the audience. Comment.

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 20.26, Q.No. 49.

1. **Appearance in Conferences & Seminars:**
   (a) Members giving talks or lectures or attending a conference may describe themselves as CAs only when they are acting in their capacity as CA. Reference to the Firm Name is not permitted.
   (b) What the Member may say or write must not be promotional of his or his Firm but must be an objective professional view of the topic under consideration.

2. Analysis and Conclusion: In the above case, the following acts of the CA in practice constitute professional misconduct under Clause 6 and 7 of Part I of First Schedule.
   (a) Reference as "Management Expert", by a CA in practice,
   (b) Disclosing nature of services rendered by the Firm, and the fee charged,
   (c) Soliciting the audience to approach his Firm of CA's,
   (d) Distribution of Business Cards with Firm Details and Telephone Numbers to the Audience.

Question 6(c): Tax Audit Applicability (4 Marks)

Mr. A engaged in business as a Sole Proprietor presented the following information to you for the FY 2012–2013. Turnover made during the year ₹ 124 Lakhs. Goods returned in respect of sales made during FY 2010–2011 is ₹ 20 Lakhs not included in the above. Cash Discount allowed to his customers ₹ 1 lakh for prompt payment. Special Rebate allowed to customer in the nature of Trade Discount ₹ 5 Lakhs. Kindly advice him whether he has to get his account audited u/s 44AB of the Income Tax Act, 1961.

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 10.2, Q.No. 5.

	Details	**₹ in Lakhs**
	Turnover during the year	124
Less:	Special Rebate to Customers in the nature of Trade discount	(5)
	Net Turnover for the purpose of Sec. 44AB	**119**

Note:

- Cash Discount for prompt payment, not shown in the Invoice, shall **not** be reduced from Turnover.
- No adjustment is required in respect of Sales Returns ₹ 20 Lakhs, since the question states that it is **not included** in the Turnover.

Conclusion: Since the Turnover exceeds the limit of ₹ 100 Lakhs specified u/s 44AB, Tax Audit is applicable.

Alternative View: It can also be assumed that ₹ 20 Lakhs Sales Returns is **yet** to be netted off against Sales of ₹ 124 Lakhs. In such case, the Turnover will be 124 – 20 – 5 = **₹ 99 Lakhs**. Tax Audit u/s 44AB is **not** applicable in such case.

Question 6(d): Corporate Governance and Audit Committee (4 Marks)

Dishonest Limited, a Company incorporated in India has six members in its Audit Committee. Due to recessionary conditions in India, the revenue of the Company is going down and there is slow down in other activities of the Company. Therefore, it was expected that there would not be significant work for members of the Audit Committee. Considering the overall recession in the Company and the economy, the members of the Committee decided unanimously to meet once in a year only on 31st March 2013. They reviewed monthly information system of the Company and found no errors. As an Auditor of Dishonest Limited would you consider the decision taken by the Audit Committee is in line with the Clause 49 of the (SEBI) Listing Agreement?

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 17.3, Q.No. 6, Point 3 and 5.

1. **Principles:** As per Clause 49 of Listing Agreement with SEBI, the following points are relevant –
   (a) **Meetings and Quorum:** The Audit Committee shall meet **atleast 4 times a year,** and not more than 4 months shall elapse between two meetings. The quorum shall be either 2 members or 1/3rd of the Members of the Audit Committee whichever is higher, and minimum of two independent Directors.
   (b) **Review of Information:** The Audit Committee shall mandatorily review the following –
   - Management discussion and analysis of financial condition and results of operations,
   - Statement of significant Related Party transactions (as defined by Audit Committee), submitted by Management,
   - Management Letters / Letters of Internal Control Weaknesses issued by the Statutory Auditors,
   - Internal Audit Reports relating to Internal Control Weaknesses, and
   - Appointment, removal and terms of remuneration of the Chief Internal Auditor.

2. **Analysis:** In the above case, the decision (even if unanimous) of the Audit Committee to meet once a ear, and review of MIS only are not correct. It **violates** the conditions specified in Clause 49 of Listing Agreement with SEBI.

Question 7(a): Peer Review (4 Marks)

Write short notes on Scope of Peer Review

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 21.2, Q.No. 4.

1. **Assurance Services:** The Peer Review Process shall apply to **all** the **assurance services** provided by a Practice Unit.
2. **Period:** Once a Practice Unit (PU) is selected for Review, its Assurance Engagement Records pertaining to the Peer Review Period shall be subjected to Review. Peer Review Period = **3 years** preceding the year in which the PU is selected, or such other period or any period as prescribed by the Peer Review Board for conducting a Peer Review.
3. **Areas covered:** The Review shall cover –
   (a) Compliance with Technical, Professional and Ethical Standards,
   (b) Quality of Reporting,
   (c) Systems and Procedures for carrying out assurance services,
   (d) Training Programmes for Staff (including Articled and Audit Assistants) concerned with assurance functions, including availability of appropriate infrastructure.
   (e) Compliance with directions and/or guidelines issued by the Council to the Members, including Fees to be charged, number of audits undertaken, register for Assurance Engagements conducted during the year and such other related records.
   (f) Compliance with directions and / or guidelines issued by the Council in relating to Articled Assistants and / or Audit Assistants, including Attendance Register, Work Diaries, Stipend Payments, and such other related records.

4. **Period of Review:** Once a PU is selected for review, its attestation engagement records pertaining to the immediately preceding **3 completed financial years only**, shall be subjected to Review since this would establish the consistency or deviations, if any, in respect of procedures followed by the Practice Unit.

Question 7(b): Cost Audit (4 Marks)

Write short notes on Cost Records in respect of By–Products.

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 7.8, Q.No. 22.

Apart from the details regarding the Main Product, the Cost Records should set out the following information in respect of By–Products –

1. **Description** of various by–products and their utility.
2. **Quantity and value** of – (a) Production, (b) Issues i.e. Sales, (c) Balance in Stock, and (d) Wastage if any.
3. Method of **assigning Joint Costs** to By–Products, which should be scientific, equitable and consistent.
4. Details of **Further Processing Costs** and Selling Expenses of By–Products.
5. Details of **Sales Realisation** of By–Products.
6. Manner of accounting for **profits** derived from sale of By–Products.

Question 7(c): Corporate Governance and Audit Committee (4 Marks)

Write short notes on Content of Management Discussion and Analysis.

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 17.9, Q.No. 19.

1. **MDA Report:** As part of the Directors' Report or as an addition thereto, a Management Discussion and Analysis (MDA) Report should form part of the Annual Report to the Shareholders. MDA should include discussion on the following matters, within the limits set by the Company's competitive position–
   (a) Industry structure and developments,
   (b) Opportunities and Threats,
   (c) Segment–wise or product–wise performance,
   (d) Outlook,
   (e) Internal Control Systems and their adequacy,
   (f) Risks and concerns,
   (g) Discussion on financial performance with respect to operational performance,
   (h) Material developments in HR/ Industrial Relations front, including number of people employed.

2. **Conflict of Interest Matters:** Senior Management shall make disclosures to the Board, relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the Company at large (e.g. dealing in Company Shares, commercial dealings with bodies, which have Shareholding of Management and their relatives, etc.)

Question 7(d): Audit of NBFCs and Co–Op Societies (4 Marks)

Write short notes on Aspects to be covered in the Books of Accounts to be maintained by a Multi–State Co–Operative Society.

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 12.14, Q.No. 20.

1. **General:** As per MSCS Rules, 2002, every MSCS shall keep books of accounts with respect to –
   (a) all sum of money received & expended and the matters in respect of which the receipt and expenditure took place.
   (b) all Sales and Purchases of goods.
   (c) the Assets and Liabilities of the Society.
   (d) in the case of a MSCS engaged in production, processing & manufacturing, particulars relating to utilization of materials or labour or other item of cost as may be specified in the Bye Laws of the Society.

2. **Books of Accounts:** Thus, the following books of accounts may be maintained –

Item	Purpose
(a) **Cash Book**	To record particulars regarding Cash Receipts and Expenses under suitable heads, with clear distinction between Capital and Revenue items of Receipts and Expenses.
(b) **Stock Register**	To record detailed, item–wise and date–wise information of Receipts, Issues and Balances of Stock–in–Trade. In a Producers Co–Operative Society, Perpetual Inventory Records may be maintained based on an appropriate costing method.
(c) **Register of Assets & Investments**	To record particulars regarding the various Immovable and Movable Assets belonging to the MSCS, by specifying details such as – Type of Assets, Location, Date of Acquisition, Cost, Depreciation provided, etc.
(d) **Register of Fixed Deposits**	In the case of a Co–Operative Credit Society, or a Co–Operative Bank, or any other Society which is authorized by its bye–laws to accept deposits from Members/ Non–Members, a Register of Fixed Deposits may be maintained giving details as regards the dates of acceptance, maturity, interest accrual, repayment, etc.
(e) **Register of Sureties**	In case of a Co–Operative Credit Society, Loans are given against personal security of Members as also Surety (Guarantee) provided by two other Members. The Register of Sureties will give particulars about the number of Borrowers in respect of which a Member has stood surety, and show whether it is within the overall limit of surety–ship that may be given by a Member as prescribed by the bye–laws.
(f) **Register of Loan Disbursement and Recovery**	In the case of a Co–Operative Credit Society, this Register will provide particulars regarding loans sanctioned by the Society, the dates of disbursement and recovery.

Question 7(e): Special Audits (4 Marks)

Write short notes on Environment Impact Assessment.

Solution: Refer Padhuka's Students' Handbook on Advanced Auditing – Page No. 13.10, Q.No. 22, Point 9.

Environmental Impact Assessment (EIA):

1. The effect of the Factory's activities on the existing environmental conditions is covered in the EIA Report. There will be deviations between the EIA Factors estimated at the time of commencement of Factory, and the actual happenings when the Factory starts working.
2. If it is observed that the degradation caused to the Environment through the Factory's activities is higher than what was predicted, the EIA Report should also contain mitigatory measures/ recommendations therefor.

STUDENTS' NOTES

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