

PAPER – 3 : ADVANCED AUDITING

QUESTIONS

1. (a) What are the main points of difference between internal audit and statutory audit?
(b) What are the different types of auditor ?
2. (a) When is a company required to appoint cost auditor?
(b) What are the qualifications and disqualifications of the cost auditor?
(c) What are the provisions regarding cost audit report?
3. What are duties of an auditor under Companies Act, 1956 regarding :
 - (a) Register of contracts with companies and firms in which the directors are interested
 - (b) Register of investment or loan made, guarantee given or security provided in relation to any body corporate
 - (c) Register of directors, managing director, manager and secretary
 - (d) Register of shareholding of directors and manager
4. (a) X, a practicing chartered accountant paid 25% of the audit fees received by him to his employee Y, who was an M.Com., under the nomenclature of office allowance and such an arrangement continued for a number of years. Comment.
(b) T, a practicing chartered accountant uses the designation, 'Municipal Councillor' apart from the expression 'FCA' on his visiting card. Comment.
5. Haidar deals in a commodity and purchase and sales of that commodity is ultimately settled otherwise than by the actual delivery. During the financial year 2007-08 he purchased the commodity worth Rs. 3500000 and sold the same commodity for Rs. 4400000 and the contract was settled otherwise than by the actual delivery. Haider seeks your advice whether he is liable for tax audit under section 44AB of the Income Tax Act.
6. Explain what is meant by "Representations by Management" and indicate to what extent an auditor can place reliance on such representations.
7. The Accounting Standards issued by the Institute of Chartered Accountants of India need to be followed only by limited companies and not by partnership firms or proprietorships. Comment.
8. What are the reporting requirements for depositing undisputed statutory dues in the Companies (Auditor's Report) Order, 2003?
9. Bring out the significance of the following two illustrative paragraphs found in the statutory auditor's report .
 - (i) Opening Paragraph:

"We have audited the attached Balance Sheet of as at 31st March, 2xxx and also the Profit and Loss Account for the year ended on that date annexed thereto. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements".

(ii) Scope Paragraph:

"We conducted our audit in accordance with the auditing standards generally accepted in India. Those standards require that we plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material statement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial presentation. We believe that our audit provides a reasonable basis for our opinion."

10. Write short notes on :
 - (a) Certificate for Special Purpose vs. Audit Report
 - (b) Substantive Procedures
 - (c) Enquiry
 - (d) Divisible profits
11. (a) What is engagement to perform agreed upon procedures?
 (b) What are the general principles governing an agreed upon procedures engagement?
12. What are the important steps involved while conducting Investigation on behalf of an Incoming Partner?
13. What are the principles involved regarding "Propriety audit" in the case of Public Sector Undertaking?
14. As a branch auditor of a nationalised bank, how would you verify the following?
 - (i) Advances to DOT COM Companies.
 - (ii) Balances in account of a bank situated in a foreign country.
15. Describe the audit procedures to be followed for verification of premiums by a statutory auditor of a general insurance company.
16. Write short notes on :
 - (a) Hit or take orders
 - (b) Sauda Book
17. Mention the duties of Auditor of Cooperative Societies in regard to the following:
 - (i) Over-due debts
 - (ii) Compliance with provisions of Cooperative Act and Rules thereunder.

(iii) Adherence to Co-operative Principles.

18. Explain in brief the behavioural aspects encountered in the management audit and state the ways to solve them.

SUGGESTED ANSWERS/HINTS

1. (a) Following are the main points of difference between internal audit and statutory audit:
 - a. Appointment : The management of the organization makes the appointment of an internal auditor. The statutory auditor is appointed by different authorities. First statutory auditors are appointed by the shareholders in the annual general meeting.
 - b. Qualification: Qualifications of the statutory auditor are prescribed in the companies act, 1956. Essentially a person should be a practicing chartered accountant to be appointed as a statutory auditor. There are no fixed qualification for the position of an internal auditor.
 - c. Objects: The main object of the statutory audit is to form an opinion on the financial statement of the organization auditor has to state that whether the financial statements are showing the true and fair view of the affairs of the organization or not. The main object of the internal audit is to detect and prevent the errors and frauds.
 - d. Scope: The scope of the statutory audit is fixed by the companies act 1956. It can not be changed by mutual consent between the auditor and the management of the audited business unit. The scope of the internal audit is fixed by the mutual consent of the auditor and the management of the unit under audit.
 - e. Remuneration: Remuneration of the statutory auditor is fixed by the appointing authority, i. e., in case of first auditors, directors fix the Remuneration. In case of the subsequent auditors, the company in its general meeting fixes the remuneration. In case of internal auditor the management who appoints him fixes his Remuneration.
 - f. Report: The statutory auditor submits his report to the shareholder of the company in its general meeting. The internal auditor submits his report to the management of the company who is also his appointing authority.
 - g. Removal: The procedure of removal of the statutory auditor is very complex. Only the company in the general meeting can remove the auditor. It also has to take the permission of the central government. The management of the entity can remove internal auditor.
- (b) The three broad groups of auditors are external, internal, and governmental. Certified public accountants (CPAs) are external, independent auditors who are

licensed by individual states to provide auditing services. The public accounting profession has played an active role in developing and providing attestation services.

Internal auditors are employees of organizations. In publicly owned companies, internal auditors typically report to senior management and the board of directors, through its audit committee. Internal auditors are primarily involved in compliance and operational audits.

Government auditors evaluate their own agencies and those for which they are responsible, including recipients of funds.

2. (a) Where a company is required to maintain the cost records as per section 209(1)(d), the Central Government may direct the company to conduct a cost audit. Cost audit is required to be conducted only if all the following conditions are satisfied :
 - The company is engaged in production, processing, manufacturing or mining activities.
 - The company pertains to the class of companies that are required by the central government to maintain the cost records.
 - An order is issued by the central government directing the company to conduct cost audit.
 - The cost audit is required only for that particular year in respect of which the cost audit order has been issued.
 - (b) Qualifications of cost auditor : The cost auditor shall be a cost accountant within the meaning of the Cost and Works Accountants Act, 1959. Provided that if the Central Government is of opinion that sufficient number of cost accountants within the meaning of the Cost and Works Accountants Act, 1959(23 of 1959), are not available for conducting the audit of cost accounts of companies generally, that Government may, by notification in the Official Gazette direct that, for such period as may be specified in the said notification, such Chartered Accountant within the meaning of the Chartered Accountants Act, 1949, as possesses the prescribed qualifications, may also conduct the audit of the cost accounts of companies and thereupon a chartered accountant possessing the prescribed qualifications may be appointed to audit the cost accounts of the company.
- Disqualifications of cost auditor : (i) A person disqualified to act as a statutory auditor of the company under section 226(3) and (4) shall not be appointed or re-appointed for conducting the audit of the cost accounts of a company.
- (ii) The statutory auditor of the company shall not be appointed as the cost auditor.
 - (iii) If a person, appointed for conducting the audit of cost accounts of a company, becomes such, after his appointment, to any of the above disqualifications , he shall, on and from the date on which he becomes so subject, cease to conduct the audit of the cost accounts of the company.

- (iv) A person who is an employee of any of the partners of a firm of chartered accountants which is appointed as company auditor under section 224 shall not be appointed as a cost auditor.
 - (v) An internal auditor of a company shall not be appointed as its cost auditor.
 - (c) 1. The cost auditor shall make his report to the Central Government in Form No. 23C within 180 days of the close of financial year. He shall also forward a copy of the report to the company.
 - 2. The company shall, within 30 days from the date of receipt of cost audit report, furnish the Central Government with full information and explanations on every reservation or qualification contained in the report of the cost auditor.
 - 3. The Central Government may call for such further information and explanation and thereupon the company shall furnish the same within such time as may be specified by the government.
 - 4. The Central Government may take such action on the report, in accordance with the provisions of the Companies Act, 1956 or any other law for the time being in the force, as it may consider necessary.
 - 5. The Central Government may direct the company to circulate to its members the whole or a portion of the cost audit report. If ordered, the report shall be circulated along with the notice of the annual general meeting to be held for the first time after the submission of such report.
 - 3. (a) Register of contracts with companies and firms in which the directors are interested - This Register is maintained pursuant to sub-section (1) of Section 301. It contains a record of particulars of contracts or arrangements that attract the provisions of Sections 297 and 299; dates of Board meetings at which contracts were approved and that of the names of directors who voted for or against the proposal. The names of firms and bodies corporate in which the Directors are interested, of which a notice has been given by the directors under sub-section 297(2)(c) are also entered in it.
- The provisions of Section 297 are not applicable to; (a) contracts or arrangements for the sale or purchase or supply of goods, materials or services, if the value or cost thereof in any year does not exceed Rs. 5000; and (b) contracts, etc., by banking companies for the collection of bills in the ordinary course of business, and transactions of banking and insurance companies in the ordinary course of business with any director, relative, partner, etc., referred to in Section 297(2) (c).
- It is the duty of the auditor to examine the Register to find out whether transactions of purchase or sale of goods in which a director or directors were interested were entered into under the sanction of the Board and the directors concerned had disclosed their interest.
- (b) Register of investment or loan made, guarantee given or security provided in relation to any body corporate - In pursuance of sub-section (5) (a) of Section

372A, every company shall keep a register showing the following particulars in respect of every investment or loan made, guarantee given or security provided by it in relation to any body corporate under sub-section (1), namely:

(i) the name of the body corporate; (ii) the amount, terms and purpose of the investment or loan or security or guarantee; (iii) the date on which the investment or loan has been made; and (iv) the date on which the guarantee has been given or security has been provided in connection with a loan.

The particulars of investment, loan, guarantee or security referred to in clause (a) shall be entered chronologically in the register aforesaid within seven days of the making of such investment or loan, or the giving of such guarantee or the provision of such security.

The register referred to in sub-section (5) shall be kept at the registered office of the company concerned shall be open to inspection at such office and extracts may be taken therefrom and copies thereof may be required, by any member of the company to the same extent, in the same manner on payment of the same fees as in the case of the register of members of the company; and the provisions of Section 163 shall apply accordingly.

- (c) Register of directors, managing director, manager and secretary - Under the provisions of Section 303 of the Companies Act, it is obligatory for a company to maintain a record, in a register, of the names and addresses and that of other particulars relevant for the administration of the Act in respect of all the officers aforementioned. Under sub-section (2) of the aforesaid Section, any change in the officers or any of the particulars of an officer must be incorporated in the register and notified to the Registrar of Companies within 30 days of the change taking place. Particulars of original appointment also should be notified to the Registrar within 30 days of appointment.

The auditor should refer to this register to find out the names of persons who had held different offices during the year under audit to confirm that various transactions entered into by the company have been authorised by a competent person.

- (d) Register of shareholding of directors and manager - It contains a record of the particulars of shares and debentures of the company, as well as those of similar securities in the capital of any other body corporate, which is a subsidiary or holding company or subsidiary of the company's holding company held by a director or which lie in trust with him or of which he has any right to become the holder whether on payment or not. This register is being maintained pursuant to the requirement under Section 307.

Where the auditor carries out a share transfer audit, he should see that the purchase and sale of shares by the directors are properly recorded in the register. But in the course of regular audit, he is not expected to check the accuracy of entries in the register.

4. (a) As per clause (2) of Part I of the First Schedule to the Chartered Accountants Act,

1949 , a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he 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 member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services to time in or outside India.

In the given case in substance the chartered accountant has shared his profit and therefore, is guilty of professional misconduct under the clause. It is not the nomenclature to a transaction that is material but it is the substance of the transaction, which has to be looked into.

- (b) As per clause (7) of Part I of the First Schedule to the Chartered Accountants Act, 1949 , a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he Advertises his professional attainments or services, or uses any designation or expressions other than the Chartered Accountant on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a University established by law in India or recognized by the Central Government or a title indicating membership of the Institute of Chartered Accountants or of any other institution that has been recognized by the Central Government or may be recognized by the Council.

Provided that a member in practice may advertise through a write up, setting out the service provided by him or his firm and particulars of his firm subject to such guidelines as may be issued by the Council.

This clause prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public.

A member must not use the designation such as 'Member of Parliament', Municipal Councillor any other functionary in addition to that of Chartered Accountant.

Therefore under this clause T is guilty of professional misconduct.

5. Haider deals in commodity as a speculator. A speculative transaction means a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scripts. Thus, in a speculative transaction, the contract for sale or purchase which is entered into is not completed by giving or receiving delivery so as to result in the sale as per value of contract note. The contract is settled otherwise and squared up by paying out the difference which may be positive or negative. As such, in such transaction the difference amount is 'turnover'. (in the given case the difference of Rs. 44 lakhs and Rs. 35 lakhs i.e, Rs. 9 Lakhs is the turnover)In the case of an assessee doing speculative transactions there can be both positive and

negative difference arising by settlement of various such contracts during the year. Each transaction resulting into whether a positive or negative difference is an independent transaction. Further, amount paid on amount of negative difference paid is not related to the amount received on account of positive difference. In such transactions though the contract notes are issued for full value of the purchased or sold asset the entries in the books of account are made only for the differences. Accordingly, the aggregate of both positive and negative differences is to be considered as the turnover of such transaction for determining the liability to audit vide section 44 AB. Therefore Haider is not liable for Tax audit under section 44AB of the Income Tax Act, 1961.

6. **Representation by Management :** The management is responsible for the appropriate preparation and presentation of financial information. Thus it is quite natural that during the course of audit, management would be required to make several representations on various matters relating to financial statements. These representations may be made by the management either in orally or in writing to the auditor. For example, the auditor may ask the management to confirm about the existence of contingent liabilities and disclosure thereof, etc. In other words, representation by management constitutes acknowledgement by the management about its responsibility for the preparation and approval of the financial information. A written representation may either take the form of a letter from the management or letter by auditor outlining auditor's understanding and confirmation of the same.

Extent of Reliance: During the course of an audit, management makes many representations to the auditor, either unsolicited or in response to specific enquiries. When such representations relate to matters which are material to the financial information, the auditor should:

- (a) seek corroborative audit evidence from sources inside or outside the entity;
- (b) evaluate whether the representations made by management appear reasonable and consistent with other audit evidence obtained, including other representations; and
- (c) consider whether the individuals making the representations can be expected to be well-informed on the matter.

Representations by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. For example, a representation by management as to the quantity, existence and cost of inventories is no substitute for adopting normal audit procedures regarding verification and valuation of inventories. If the auditor is unable to obtain sufficient appropriate audit evidence that he believes would be available regarding a matter which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter.

In certain instances such as where knowledge of the facts is confined to management or where the matter is principally one of intention, a representation by management may be the only audit evidence which can reasonably be expected to be available; for example, intention of management to hold a specific investment for long-term appreciation. If a

representation by management is contradicted by other evidence, the auditor should examine the circumstances and, when necessary, reconsider the reliability of other representations made by the management as well.

7. **Applicability of Accounting Standards:** The Preface to the Statements of Accounting Standards clarifies that the Accounting Standards are issued "for use in the presentation of general purpose financial statements issued to the public by such commercial, industrial or business enterprises, as may be specified by the Institute from time to time and subject to the attest function of its members. The term 'General Purpose Financial Statements' includes balance sheet, statement of profit and loss and other statements and explanatory notes which form part thereof, issued for use of shareholders/ members, creditors, employees and public at large". As far as companies, whether limited or unlimited incorporated under the Companies Act, 1956 are concerned, all such companies are expected to adhere to specified accounting standards in terms of section 211(3A) of the said Act. Even otherwise, such a requirement seems to be implicit even in the absence of specific statutory provisions since the application of accounting standards is an integral component so as to ensure that the financial statements give a true and fair view. Accordingly, the compliance with accounting standards has to be examined by the auditors while auditing general purpose financial statements which are statutorily required to be audited under any law. Thus, compliance with accounting standards is required to be examined by an auditor in an audit of financial statements of individuals and non-corporate enterprises (viz., sole proprietary concerns, partnership firms, societies registered under the Societies Registration Act, trusts, Hindu Undivided Families, and associations of persons) only where the financial statements are statutorily required to be audited under any law. The accounting standards are also applicable to commercial, industrial or business activities of even charitable or religious organisations. Accounting Standards do not apply to those organisations whose entire activities are not of commercial, industrial or business nature, e.g., an organisation collecting donations to finance education of poor children. However, even if a very small proportion of the activities of an entity is commercial, industrial or business in nature, the accounting standards will apply to all its activities. Thus, the Council has made it clear that compliance with accounting standards required to be examined in an audit of financial statements of non-corporate enterprises only where the financial statements are required to be audited under any statutory enactment. For instance, in case there is no statutory requirement for such entities to prepare accounts on accrual basis, the auditor would not qualify but simply disclose the basis of accounting followed. Therefore, accounting standards are applicable not only to limited companies but also to partnership firms or proprietorships.
8. (a) Paragraph 4(ix)(a) of CARO, 2003 requires the auditor to report upon the regularity of the company in depositing undisputed statutory dues including provident fund, investor education and protection fund, employees' state insurance, income-tax, sales-tax, wealth-tax, service tax, custom duty, excise duty, cess and any other statutory dues to appropriate authorities. If the company is not regular in depositing the above mentioned undisputed statutory dues, the auditor is required to state the

extent of arrears of statutory dues which have remained outstanding as at the last day of the financial year concerned for a period of more than six months from the date they became payable.

Apart from the statutory dues listed, the auditor is required to report on the regularity of the company in depositing "any other statutory dues" payable by the company to appropriate authorities under the statutes applicable to the company.

Since the emphasis of the clause is on the regularity, the scope of auditor's inquiry is restricted to only those statutory dues, which the company is required to deposit regularly to an authority. The auditor is not required to ascertain whether the company is regular in depositing amounts, which may be levied by an appropriate authority from time to time upon occurrence or non-occurrence of certain events and therefore are not required to be paid regularly. Any sum, which is to be regularly paid to an appropriate authority under a statute (whether Central, State or Local or foreign) applicable to the company, should be considered as a "statutory due" for the purpose of this clause. Thus, examples of "statutory dues" would include municipal taxes, taxes deducted at source, fees payable to the licensing authority in respect of business being carried on under license granted by an authority, say a cinema hall. Accordingly, any sum payable to an electricity company as electricity bill would not constitute a statutory due despite the fact that such a company has been established under a statute.

Non-payment of advance income tax would constitute default in payment of statutory dues. It may, however, happen that the company might not have any taxable income on the due dates on which advance tax is required to be paid. If such a company has an income after the last date on which the advance tax was required to be paid and consequently the company incurs interest under the relevant provisions of the Income Tax Act, 1961, it should not be construed that the company is not regular in depositing advance tax.

It may be noted that the auditor has to report on the regularity of deposit of statutory dues irrespective of the fact whether or not there are any arrears on the balance sheet date. This is because there may be situations where a company has deposited the relevant dues before the end of the year while it has been in default in the matter for a significant part of the year. In cases where there are no arrears on the balance sheet date but the company has been irregular during the year in depositing the statutory dues, the auditor should state this fact in his audit report.

For the purpose of this clause, the auditor should consider a matter as "disputed" where there is a positive evidence or action on the part of the company to show that it has not accepted the demand for payment of tax or duty, e.g., where it has gone into appeal. For this purpose, where an application for rectification of mistake (e.g., under section 154 of the Income Tax Act, 1961) has been made by the company, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of a statutory due is for a certain amount and the dispute relates only to a part and not the whole of such amount, only such amount should be treated as

disputed and the balance amount should be regarded as undisputed. It is not necessary for the auditor to examine the sustainability or otherwise of the claim of the company regarding disputed amounts. It is sufficient for his purpose if the evidence available shows that the amount is disputed by the company. It may also be noted that the Order has clarified that mere representation to the concerned Department does not constitute the dispute.

It may be noted that penalty and/or interest levied under the respective laws would be covered within the term "amounts payable".

While the auditor has to report upon the regularity of the deposit, he is not required to specify in detail each instance where there has been a delay or the extent of the delay. It should be sufficient if he indicates whether generally the deposits have been regular or otherwise. The following are examples of the wordings, which may be used in relevant situations:

"undisputed statutory dues including provident fund, investor education and protection fund, or employees' state insurance, income-tax, sales-tax, wealth tax, service tax, custom duty, excise duty, cess have been regularly deposited by the company with the appropriate authorities in all cases during the year".

"undisputed statutory dues including provident fund, investor education and protection fund, employees' state insurance, income-tax, sales-tax, wealth tax, service tax, custom duty, excise duty, cess have generally been regularly deposited with the appropriate authorities though there has been a slight delay in a few cases".

"undisputed statutory dues including provident fund, investor education and protection fund, employees' state insurance, income-tax, sales-tax, wealth tax, service tax, custom duty, excise duty, cess have not generally been regularly deposited with the appropriate authorities though the delays in deposit have not been serious".

"undisputed statutory dues including provident fund, investor education and protection fund, employees' state insurance, income-tax, sales-tax, wealth tax, service tax, custom duty, excise duty, cess have not been regularly deposited with the appropriate authorities and there have been serious delays in a large number of cases".

If the auditor is of the opinion that the company is not regular in depositing undisputed statutory dues including provident fund, investor education and protection fund, employees' state insurance, income-tax, sales-tax, wealth tax, service tax, custom duty, excise duty, cess and any other statutory dues with the appropriate authorities, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, are required to be mentioned by the auditor in his audit report. In indicating the arrears, the period to which the arrears relate

should also preferably be given and further, wherever possible, the fact of subsequent clearance or otherwise may also be indicated

9. (i) **Opening Paragraph:** The opening or introductory paragraph identifies the financial statements of the entity that have been audited, including the date of and period covered by the financial statements. Further, the significance of 'opening paragraph' is to bring to the notice of the users of financial statements that preparation of the accounts is the responsibility of the management of the enterprise, whereas the responsibility of the auditor is to express an opinion on the said accounts based on audit carried out by him. The preparation of such statements requires management to make significant accounting estimates and judgements, as well as to determine the appropriate accounting principles and methods used in preparation of the said statements.
- (ii) **Scope Paragraph:** The significance of 'scope paragraph' is to inform the users about the practices and procedures followed in conduct of audit by the auditor. The auditor states in this paragraph that the audit was planned and performed in accordance with generally auditing standards generally accepted in India. The auditor also states that the audit provides a reasonable basis for his opinion. The significance of this paragraph lies in the fact that auditor wishes to convey to readers about the scope of audit by highlighting the nature and process of audit. The test check approach of audit adopted by the auditor in performing his work as also the significant aspect of evaluation of accounting principles and accounting estimates is also clarified. The basic objective of auditing that the auditor provides only "reasonable assurance" is emphasised in this paragraph. In a way, such a statement signifies inherent limitations of audit.
10. (a) **Certificate for Special Purpose vs. Audit Report:** A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. Government authorities may, under various statutes or notifications, require reports or certificates from auditors in support of statements or other information prepared by an enterprise. Reports or certificates on specific matters may also be required from auditors by an enterprise, for its own special purposes. These reports or a certificate to specific requirements of the individual users is unlike a 'general purposes report' e.g. an auditor's report on financial statements which is intended for general use. A report, on the other hand, is a formal statement usually made after an enquiry, examination or reviews of specified matters under report and includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein, e.g., certification of export turnover, etc. On the other hand, when the reporting auditor gives the report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill.

- (b) Substantive Procedures: AAS- 1 on “Basic Principles Governing an Audit”, lists ‘audit evidence’ as one of the basic principles governing an audit of financial statements. AAS-1 requires that an auditor should perform audit procedures, viz., compliance procedures and substantive procedures to obtain sufficient and appropriate evidence.

As per AAS- 1, substantive procedures are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. These procedures comprise tests of details of transactions and balances and analysis of significant ratios and trends including the resulting investigation of unusual fluctuations and items.

Obtaining audit evidence from substantive procedures is intended to reasonably assure the auditor in respect of the following assertions:

Existence	- that an asset or a liability exists at a given date.
Rights and Obligations	- that an asset is a right of the entity and a liability is an obligation of the entity at a given date.
Occurrence	- that a transaction or event took place which pertains to the entity during the relevant period.
Completeness	- that there are no unrecorded assets, liabilities or transactions.
Valuation	- that an asset or liability is recorded at an appropriate carrying value.
Measurement	- that a transaction is recorded in the proper amount and revenue or expense is allocated to the proper period.
Presentation and Disclosure	- an item is disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

The extent and nature of substantive procedures to be performed will vary with respect to each of the above assertions. Obtaining evidence relevant to one of the above assertions will not compensate for failure to do so with respect to another matter concerning the same item, e.g., existence of inventory and its valuation.

Substantive procedures are classified in two categories, viz., tests of detail and analytical procedures. Tests of details involve vouching which primarily deals with transactions and verification normally deals with balances contained in the balance sheet. By performing analytical procedures which aim at calculation of ratios,

trends, etc. also aim to provide the auditor with substantive evidence to validate the items contained in financial statements. Such procedures are normally conducted after the auditor has conducted compliance procedures and will be affected by the following factors:

- Results of the compliance procedures
 - Responses to inquiries as to whether the internal system is functioning
 - Auditors' evaluation of the internal control environment, especially supervisory controls
 - Nature and amount of the transactions or balances involved
- (c) **Enquiry:** AAS 5 "Audit Evidence" mentions inquiry as one of the methods of collecting audit evidence by seeking appropriate information from knowledgeable persons inside or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to enquiries may provide the auditor with information, which he did not previously possess or may not provide him with corroborative evidence. The need for inquiry may arise at every stage of auditing. Wherever any transaction or entry is not readily understandable or its effects are not readily apparent, the auditor should not hesitate to make enquiry from the appropriate official of the client. Apart from this, the auditor of a company has to make a statement in his report on whether he has obtained all the information and explanations that he considered necessary for his audit. This requirement suggests that inquiry is one of the process of the whole scheme of auditing and, accordingly, the Companies Act, 1956 has given certain powers to the auditor in section 227(1) and has cast certain duties on company officials in section 221. Besides, section 227(1A) requires the auditor to make certain specific enquiries during the course of his audit. This requirement is without prejudice to his general rights, powers and duties regarding access to books, etc., and obtaining information and explanations. He is, however, not required to report on the matters specified in this sub-section, unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied.
- (d) **Divisible Profits:** Divisible profits are profits available for distribution to shareholders as dividends. It is different from book profit or economist's concept of profit. It represents those profits which are legally available for distribution as dividends. In the earlier years there were disputes whether depreciation should be provided before declaration of dividend or not; there were disputes whether capital profits or profits on revaluation of assets are available for distribution. Now these controversies stand resolved through the provisions of Companies Act, 1956 and also the judicial pronouncements over the years.

Section 205 prohibits a company from declaring dividends out of its profits before providing for depreciation in the manner laid down in the section. Depreciation should be provided as per rates/methods prescribed in Schedule XIV of the Act; not

only for the year for which dividend is declared but also in respect of preceding financial year or years [since the commencement of Companies (Amendment) Act, 1960] for which adequate depreciation had not been provided in the books. If a loss has been incurred in the past which remains debited in the accounts then the amount of loss or the amount of depreciation whichever is less should be provided in the books before any dividend is declared. Under section 205(2A), the central government has the power to make rules regarding transfer of profits by a company to its reserves before any dividend can be declared.

Dividends may be declared out of the profits of the company for the current year after providing for depreciation. However, a company is required to transfer a prescribed percentage of its profits to reserves before declaring dividends. According to the rules framed by the central government in this regard, no dividend can be declared or paid by a company for any financial year out of its profits for that year unless it transfers a percentage of its profits for that year to reserve. The second source of dividends are the reserves created out of the undistributed profits of any previous financial years after providing for depreciation. Section 205A(3) of the Act provides that dividends can be declared out of the reserves only in accordance with the rules framed by the central government in this behalf. A declaration which is not in accordance with such rules can be made only with the previous approval of the central government. A company can also declare dividends out of the moneys provided by the central government or a state government for payment of such dividend in pursuance of a guarantee given by that government.

An auditor should be fully acquainted with all legal implications of dividends. Not only should he take into account the provisions of the Companies Act (specially sections 205-208), but he should also consider the contractual and other legal obligations which determine the divisibility of profits. It cannot be over-emphasised that a dividend beyond what is legally permissible can give rise to legal action, since it would be construed as a payment out of capital. Hence, the first task of the auditor is to ensure that the dividends payable are within the legally permissible limits.

In ascertaining divisible profits, in the following circumstances, capital profits are included provided:

- (i) the capital profits remain after a revaluation of all assets and liabilities;
- (ii) the capital profit is realised in cash; and
- (iii) the articles of association permits of such distribution.

11. (a) In an engagement to perform agreed-upon procedures, the auditor is engaged by the client to issue a report of factual findings, based on specified procedures performed on specified subject matter of specified elements, accounts or items of a financial statement. For example, an engagement to perform agreed-upon procedures may require the auditor to perform certain procedures concerning individual items of financial data, say, accounts payable, accounts receivable,

purchases from related parties and sales and profits of a segment of an entity, or a financial statement, say, a balance sheet or even a complete set of financial statements.

- (b) As per AAS 32 'Engagement to perform agreed upon procedures' the auditor should comply with the Code of Ethics, issued by the Institute of Chartered Accountants of India. Ethical principles governing the auditor's professional responsibilities for this type of engagement are:

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;
- (d) Confidentiality;
- (e) Professional conduct; and
- (f) Technical standards

Independence is not a requirement for agreed-upon procedures engagement; however, the terms or objective of the engagement may require the auditor to comply with the independence requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India. Where the auditor is not independent, a statement to that effect should be made in the report of factual findings.

The auditor should conduct an agreed-upon procedure engagement in accordance with AAS 32 'Engagement to perform agreed upon procedures' and the terms of the engagement.

12. Steps involved while conducting investigation on behalf of an incoming partner: The general approach of the investigating accountant in this type of investigation would be more or less similar, irrespective of the nature of business of the firm-manufacturing, trading or rendering a service. Primarily, an incoming partner would be interested to know whether the terms offered to him are reasonable having regard to the nature of the business, profit records, capital distribution, personal capability of existing partners, socio-economic setting, etc. and whether he would be capable for services to be rendered, which can be justified by the overall economic conditions prevailing and other considerations considering his own personality and achievements. In addition, he would be interested to ascertain whether the capital to be contributed by him would be safe and applied usefully. Broadly, the steps involved are as under :

- (a) Ascertaining the history of the firm since inception and growth of the firm.
- (b) Studies of the provisions of the Deed of Partnership, particularly for composition of partners, their capital contribution, drawing rights, retirement benefits, job allocation, etc.
- (c) Scrutiny of the record of profitability of the firm's business over a suitable number of years, with usual adjustments that are necessary in ascertaining the true record of business profits. Particular attention should, however, be paid to the nature and

profitability of the business, qualification and expertise of the partners and such others as may be relevant.

- (d) Examination of the asset and liability position to determine the tangible asset, partners, investment, appraisal of the value of intangibles like goodwill, knowhow, patents, etc impending liabilities including contingent liabilities and those for pending tax assessment.
 - (e) Assess position of order at hand and the range and quality of clientele should be thoroughly examined under which the firm is presently operating.
 - (f) Scrutinise terms of loan finance to assess its usefulness and the implication for the overall financial position.
 - (g) Study important contractual and legal obligations should be ascertained and their nature studied. It may be the case that the firm has standing agreement with the employees as regards salary and wages, bonus, gratuity and other incidental benefits. Full import of such standing agreements would be gauged before a final decision is reached.
 - (h) Study the composition and quality of key personnel employed by the firm and any likelihood of their leaving the organisation.
 - (i) Ascertain reasons for the offer of admission to a new partner and it should be determined whether the same synchronizes with the retirement of any senior partner whose association may have had considerable impact having on the firm's successes.
 - (j) Appraisal of the record of capital employed and the rate of returns. It is necessary to have a comparison with alternative business avenues for investments and evaluation of possible results on a changed capital and organisation structure.
 - (k) Ascertain manner of computation of goodwill on admission as also on retirement, if any.
 - (l) Examine whether any special clause exist in the Deed of Partnership to allow admission in future a new partner.
13. Section 619 of the Companies Act, 1956 lays down special provisions regarding audit of accounts of public sector undertakings registered as Government Companies. Section 619(4) of the Companies Act, 1956 empowers C&AG to conduct supplementary or test audit. Audit of public enterprises in India is not restricted to financial and compliance audit; it extends also to efficiency, economy and effectiveness with which these operate and fulfill their objectives and goals. Another aspect of audit relates to questions of propriety; this audit is directed towards an examination of management decisions in sales, purchases, contracts, etc. to see whether these have been taken in the best interests of the undertaking and conform to accepted principles of financial propriety. Propriety audit stands for verification of transactions on the tests of public interest, commonly accepted customs and standards of conduct. On an analysis, these tests boil down to tests of economy, efficiency and faithfulness. Instead of too much dependence

on documents, vouchers and evidence, it shifts the emphasis to the substance of transactions and looks into the appropriateness thereof on a consideration of financial prudence, public interest and prevention of wasteful expenditure. Thus, propriety audit is concerned with scrutiny of executive actions and decisions bearing on financial and profit and loss situation of the company, with special regard to public interest and commonly accepted customs and standards of conduct. It is also seen whether every officer has exercised the same vigilance in respect of expenditure incurred from public money, as a person of ordinary prudence would exercise in respect of expenditure of his own money under similar circumstances. Some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

- (i) The expenditure should not be prima facie more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.
- (ii) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.
- (iii) Public moneys should not be utilised for the benefit of a particular person or section of the community unless:
 - (a) the amount of expenditure involved is insignificant; or
 - (b) the expenditure is in pursuance of a recognised policy or custom; and
 - (c) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

It may be stated that it is the responsibility of the executive departments to enforce economy in public expenditure. The aim of propriety audit is to bring to the notice of the proper authorities of wastefulness in public administration and cases of improper; avoidable and infructuous expenditure.

- 14. (i) Advances to DOT COM Companies
 - (1) Evaluate the efficacy of internal control system in general to ascertain whether an advance is made only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank. The sanction for an advance must specify, among other things, the limit of borrowing, nature of security, margin to be kept, interest, terms of repayment, etc. Also see that all the necessary documents, e.g., agreements, demand promissory notes, letters of hypothecation, etc. have been executed by the parties before advances are made.
 - (2) Examine loan documents such as certificate of commencement of business (in the case of public limited companies), resolution of board of directors, and

resolution of shareholders (in cases covered by section 293(1)(d) of the Companies Act, 1956).

- (3) Verify the business plan of the company especially where the revenue model is in place. Verify whether the company depends only on outside funding or can self generate funds.
 - (4) Examine in case the security is in the form of mortgage, apart from mortgage deed (in the case of English Mortgage) or letter of intent to create mortgage (in the case of Equitable Mortgage), the evidence of registration of the charge with the Registrar of Companies.
 - (5) Review the operation of advance account to see that limit is not generally exceeded; that the account is not becoming stagnant; that the customer is not drawing against deposits which are not free from lien; that the account is not window-dressed by running down overdrafts at the year end and again drawing further advances in the new year, etc.
 - (6) Examine whether there is a healthy turnover in the account. It should be seen that the frequency and the amounts of credits in the account are commensurate with the sanctioned limit and the nature and volume of business of the borrower. Any unusual items in the account should be carefully examined by the auditor. If the auditor's review indicates any unhealthy trends, the account should be further examined. The auditor's examination should also cover transactions in the post-balance sheet date period. Large transactions in major accounts particularly as at the year-end may be looked into to identify any irregularities in these accounts.
 - (7) Review periodic statements, cash flow statements, latest financial statements, etc. to assess the recoverability of advances.
 - (8) Verify whether the advance is secured and determine whether the security is legally enforceable, i.e., whether the necessary legal formalities regarding documentation, registration, etc., have been complied with; whether the security is in the effective control of the bank; and to what extent the value of the security, assessed realistically, covers the amount outstanding in the advance.
 - (9) Ensure that proper provisioning norms have been applied in view of non-observance of terms, coupled with irregular payment of interest and default in repayment of instalments, if any.
- (ii) Balances in Account of a Bank situated in a Foreign Country
- (1) Verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at the year-end.
 - (2) Review the reconciliation statements and pay particular attention to the following.
 - (i) Examine that no debit for charges or credit for interest is outstanding and

all the items which ought to have been taken to revenue for the year have been so taken. This should be particularly observed when the bills collected, etc., are credited with net amount and entries for commission, etc. are not made separately in the statement of account.

- (ii) Examine that no cheque sent or received in clearing is outstanding. As per the practice prevalent among banks, any cheques returned unpaid are accounted for on the same day on which they were sent in clearing or on the following day.
 - (iii) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.
 - (3) Examine the large transactions in inter-bank accounts, particularly towards the year-end, to ensure that no transactions have been put through for window-dressing.
 - (4) Check original deposit receipts in respect of balances in deposit accounts in addition to confirmation certificates obtained from banks in respect of outstanding deposits.
 - (5) Check whether these balances are converted into the Indian currency at the exchange rates prevailing on the balance sheet date and ensure compliance with AS-11 on "Accounting for the Effects of Changes in Foreign Exchange Rates".
15. Verification of Premiums: In the audit of a general insurance company, verification of premium is one of the most important aspects for the statutory auditor. The following procedure should normally be applied for verification of premium:
- (i) Ascertain that all the cover notes relating to the risks assumed have been serially numbered for each class of business.
 - (ii) Ensure that the premium in respect of risks starting during the relevant accounting year has been accounted as premium income of that year but pertaining to risk commencing in the following year has been accounted as "Premium Received in Advance".
 - (iii) Verify the collections lodged by the agents after the balance sheet date to see whether any collection pertains to risk commencing for the year under audit. The auditor should also check that the premium has been recorded originally at the gross figure without providing for unexpired risks and re insurances.
 - (iv) In case of co-insurance business, the auditor should see that the company's share of premium has been accounted for on the basis of the available information on nature of risk and the provisional premium charged by the leading insurer.
 - (v) Check whether premium register have been maintained chronologically, for each underwriting department, giving full particulars including service tax charged as per acceptance advise on the day to day basis.

- (vi) Verify the year-end transactions to check that the amounts received during the year in respect of risks commencing or installments falling due on or after the first day of the next financial year are not credited to premium account but to Premium Received in Advance Account.
 - (vii) Verify the collections remitted by the agents after the cut-off date to verify the risks assumed during the year for those collections. If the premium originally received has been refunded, the auditor should verify whether the agency commission paid on such premium has been recovered from the agent.
16. (a) Hit or Take Orders: Hit or take orders occur in screen-based trading in stock exchange. This is a variation of market orders. It allows for faster order execution without cluttering up the limit order book. This method converts the key strokes or mouse clicks of the broker into a limit order at the touch line price for a particular scrip, without his having to place a limit order. Further all unexecuted orders of this type are automatically killed and are therefore not stored in the order book.
- A broker interested in a particular scrip would ask the system to display the touch line of that scrip. He would then operate certain predefined keys or mouse clicks which would be different for buy and sell orders. The system would ask the broker to identify the client (may be skipped) and to quantify the order. The system, would then convert his buy or sell order for the quantity specified into a limit order and attach the touchline offer price for a buy order or a touchline bid price for a sell order. This order will be matched against jobber quotes and the order book for the quantity can be executed. The unexecuted quantity, if any, will be killed and removed from the system.
- (b) Sauda Book: All members of a stock exchange are required to maintain a 'Sauda Book', which contains details of all deals transacted by them on a day to day basis. This is a basic record, which each member is required to maintain regularly on day-to-day basis. It contains the details regarding the name of the code of the client on whose behalf the deals have been done, rate and quantity of bought or sold. These details are maintained datewise. This register contains all the transactions, which may be of any of the kind mentioned below :
- member's own business on the Exchange,
 - member's business on the Exchange on behalf of clients,
 - member's business with the clients on principal-to-principal basis,
 - member's business with the members of other Stock Exchanges,
 - member's business on behalf of his clients with the members of other Stock Exchanges, and
 - spot transactions, etc.
17. (i) Examination of overdue debts: Overdue debts for a period from six months to five, years and more than five years will have to be classified and shall have to be

reported by an auditor. Overdue debts have far reaching consequences on the working of a credit society. It affects its working capital position. A further analysis of these overdue debts from the viewpoint of chances of recovery will have to be made, and they will have to be classified as good or bad. The auditor will have to ascertain whether proper provisions for doubtful debts is made and whether the same is satisfactory. The percentage of overdue debts to the working, capital and loans advanced will have to be compared with last year, so as to see whether the trend is increasing or decreasing whether due and proper actions for recovery are taken, the position regarding cases in co-operative courts, District Courts etc. and the results thereof.

- (ii) **Compliance with provisions of the Act and Rules:** An auditor of a cooperative society is required to point out the infringement with the provisions of the relevant Cooperative Act Rules and bye-laws. The auditor of a cooperative society is also required to point out various irregularities, improprieties, and departure from the provision of the Act, rules framed thereunder and the bye-laws of the society. The financial implications of such infringements should be properly assessed and quantified by the auditor and they should be reported. Some of the State laws contain restrictions on the payment of dividends, which should be noted by the auditor and if dividend is declared in excess of the prescribed percentage, the fact should be reported by the auditor. Auditor should also ensure that various provisions in the Cooperative Societies Act, such as, restriction on borrowings, investment of funds, contribution to education funds, restriction on loans, etc are also complied with.
 - (iii) **Adherence to Co-operative Principles:** The auditor will have to ascertain in general, how far the objects, for which the co-operative organisation is set up, have been achieved in the course of its working. The assessment is not necessarily in terms of profits, but in terms of extending of benefits to members who have formed the society. Considered from the viewpoint of social benefits it may be looked into that how far the sales could be effected at lower prices. For the achievement of these activities, cost accounting methods, store control methods, techniques of standard costing, budgetary control etc. should be adopted. However, these modern techniques are mostly not in application and as such in practice a wide gap is found in the goals to be achieved and the actual achievements. While auditing the expenses the auditor should see that they are economically incurred and there is no wastage of funds. Middlemen commissions are, as far as possible, avoided and the purchases are made by the committee members directly from the wholesalers. The principles of propriety audit should be followed for the purpose.
18. **Behavioural aspects encountered in Management Audit :** Financial auditors deal mainly with figures. Management auditors deal mainly with people. There are many causes for behavioural problems arising in the review function of management audit. Particularly, when management auditors performs comprehensive audit of operations, they cannot be as well informed about such operations as a financial auditor in a financial department. Operating processes may be unfamiliar and complex. The operating people

may be speaking a language and using terms that are foreign to the auditor's experience. The nature and causes of behavioural problems that the management auditor is likely to face in the discharge of the review function that is expected of him and possible solutions to overcome these problems are discussed below:

- (1) **Staff / Line conflict:** Management auditors are staff people while the members of other departments are line people. Management auditors tend to discount the difficulties the line staff may face, if called on to act on the ideas of management auditors. Management auditors are specialists in their field and they may think their approach and solutions are the only answers.
- (2) **Control:** The management auditor is expected to evaluate the effectiveness of controls, there is an instinctive reaction from the auditee that the report of the auditor may affect them. There is a fear that the action taken based on the management audit report will affect the line people. It breeds antagonism. The causes are as under:
 - (i) Fear of criticism stemming from adverse audit findings.
 - (ii) Fear of change in day to day working habits because of changes resulting from audit recommendations.
 - (iii) Punitive action by superior prompted by reported deficiencies.
 - (iv) Insensitive audit practices.
 - (v) Hostile audit style.

Solution to behavioural problems: The following steps may be taken to overcome the aforesaid problems:

- (i) To demonstrate that audit is part of an overall programme of review for protective and constructive benefit.
- (ii) To demonstrate the objective of review is to provide maximum service in all feasible managerial dimensions.
- (iii) To demonstrate the review will be with minimum interference with regular operation.
- (iv) The responsible officers will be involved in the process of review of the findings and recommendations before the audit report is formally released.

It is essential to create an atmosphere of trust and friendliness so that audit reports will be understood in their proper perspective.

Finally, it needs hardly any emphasis that there should be right management culture, enlightened auditees and auditors of the right calibre. May be to expect a combination at all times of all the three is asking for the impossible. But, a concerted effort by the management, auditors and auditees to achieve a more acceptable climate would go a long way to achieve the goal.