

PAPER – 3 : ADVANCED AUDITING

QUESTIONS

1. Write short notes on the following:
 - (a) Auditor's responsibilities regarding comparatives.
 - (b) Treatment of foreign currency monetary items on balance sheet date.
2. What are your views on the following?
 - (a) Arya Ltd. was under audit for the year-ended 31.03.2006. An appeal filed by Arya Ltd. against the demand of Excise Duty of Rs. 26 crores was pending before the Supreme Court for which neither provision was made nor was disclosed in the notes to the financial statements. On 12th July, 2006, the auditor came to know through paper reports that the point involved in the appeal of Arya Ltd. was adjudicated by the Supreme Court in the case of some other assessee, which is in favour of the department of Excise Duty. The auditor insisted that provisions be made of Rs. 26 crores in the financial statements. The Management was of the view that since its own case is still pending, no provision is called for. It was also of the view that the event does not have any effect on the financial position of the company on the date of the Balance Sheet. Is the view of the Management tenable?
 - (b) Surya Industries Ltd. has a paid up capital of Rs. 20 crores divided into equity shares of Rs. 10 each as on 31.03.2006. During the financial year 2006-07 it has issued bonus shares in the ratio 1: 1. The net profit after tax for the years 31-03.2006 and 31.3.2007 is Rs. 10 crores and Rs. 15 crores respectively. The Earnings Per Share (EPS) disclosed in the financial statements for the above two years is Rs. 5.00 and Rs. 3.75 respectively. Is the disclosure correct?
 - (c) An auditor of MohanLtd. was not able to get the confirmation about the existence and value of certain machineries. However, the management gave him a certificate to prove the existence and value of the machinery as appearing in the books of account. The auditor accepted the same without any further procedure and signed the audit report. Is he right in his approach?
 - (d) A firm of a father and a son is receiving Rs. 2 lakhs towards job work done for XYZ Ltd. during the year ended on 31.03.07. The total job work charges paid by XYZ Ltd. during the year are over Rs. 50 lakhs. The father is a Managing Director of XYZ Ltd. having substantial holding. The Managing Director told the auditor that since he is not involved in the activities of the firm and since the amount paid to it is insignificant; there is no need to disclose the transaction. He further contended that such a payment made in the last year was not disclosed. Is Managing Director right in his approach?

3. Do you approve of the following? If not, why?
- (a) Shakti Pan Masala (P) Ltd. was incurring heavy losses in the last several years since it could not withstand the competition in the market. The State in which the company had its registered office and also its major sales had moved a bill in the State Assembly to ban manufacture and sale of all kinds of Pan Masalas in the State. While finalizing the accounts for the year ended 31-03-2007, the CFO of the company created a Deferred Tax Asset for the tax benefits that would arise in future years from the earlier years losses that had remained unabsorbed in Income Tax.
 - (b) Big Ltd. has borrowed Rs. 30 lakhs from State Bank of India during the financial year 2006-07. The borrowings are used to invest in shares of Small Ltd., a subsidiary company of Big Ltd., which is implementing a new project estimated to cost Rs. 50 lakhs. As on 31st March 2007, since the said project was not complete, the directors of Big Ltd. resolved to capitalize the interest accruing on borrowings amounting to Rs. 4 lakhs and add it to the cost of investments.
4. Answer the following:
- (a) Enumerate, in brief, the important aspects to be evaluated by the external auditor in determining the efficiency and extent of reliance to be placed on the work and function of an Internal Auditor.
 - (b) While compiling the financial statements of a concern, you observed that the input information supplied by the concern is incomplete, incorrect and few of the Accounting Standards have not been followed. Describe, in brief, the procedure you will follow in the above.
5. Write short note on - Cut-off Procedures
6. "Surprise Checks" help the auditors to ascertain whether the internal control system is operating effectively in a Company or not. Discuss.
7. Write short explanatory note on - Flow chart technique for evaluation of internal control.
8. Briefly describe the reporting requirements by a statutory auditor of a company for personal expenses of directors.
9. Is the auditor of a company supposed to refer any paragraph in Director's report in his own report to the shareholders of the company? State your views in this regard.
10. Write short notes on the following:
- (i) Decision Tree
 - (ii) Utility Routine
11. You are the internal auditor of AB Manufacturing Co. Ltd. The Managing Director has asked you to enquire into the causes of abnormal wastage of raw materials during the month of September, 2007.

The wastage percentages are as follows:

June, 2007	1.2%
July, 2007	1.1%
August, 2007	1.3%
September, 2007	3.6%

How will you proceed to carry out the Assignment?

12. What is the significance of the two schedules referred to in Section 21 of the Chartered Accountants Act, 1949? Whether members in service are liable to disciplinary action, and, if so, under what circumstances?
13. Write short note on - Advantages of Cost Audit to Government.
14. As statutory central auditors of a Nationalized bank, what special points are to be borne in mind in the audit of compliance with "Statutory Liquidity Ratio" (SLR) requirements?
15. Enumerate the steps to be taken by an auditor for the verification of Re-insurance outward by a General Insurance Company.
16. A leading jewellery merchant used to value his inventory at cost on LIFO basis. However, for the current year, in view of requirements of AAS-2 (SA 200 A) , he changed over to FIFO method of valuation. The difference in value of stock amounted to Rs.55 lakhs which is higher than that under the previous method. In such a situation, what are the reporting responsibilities of a Tax Audit under Section 44AB of Income Tax Act, 1961
17. Write short note on Environmental audit
18. Write short note on - Auditor's liability in case of unlawful acts or defaults by clients
19. Briefly explain " Other Misconduct".
20. As a practising chartered accountant do you approve the following? If not, why?
 - (a) In a representation to be submitted to a company under section 225(3) of the Companies Act, 1956, the partner of the firm of auditors wants to include the contributions made by the firm in strengthening the control procedures of the company during their association with the company.
 - (b) A partner of a firm of chartered accountants during a T.V. interview handed over a bio-data of his firm to the chairperson. Such bio-data detailed the standing of the international firm with which the firm was associated. It also detailed the achievements of the concerned partner and his recognition as an expert in the field of taxation in the country. The chairperson read out the said bio-data during the interview.

- (c) The Chairman of an Audit Committee of a Bluechip Company, who is a chartered accountant asked the firm in which he was previously a partner to quote their fee on a success fee basis so as to ensure that a professional work is assigned to such firm.
- (d) A firm of chartered accountants were appointed by a company to evaluate the costs of the various products manufactured by it for their information system. One of the partners of the firm of chartered accountants was a non-executive director of the company.

SUGGESTED ANSWERS/HINTS

1. (a) Auditor's responsibilities regarding comparatives: AAS 25(SA 710), "Comparatives", establishes standards on the auditor's responsibilities regarding comparatives.

The auditor responsibilities laid down are as under:

- (i) The auditor should determine whether the comparatives comply, in all material respects with the financial reporting framework relevant to the financial statements being audited. Further, the auditor should obtain sufficient appropriate audit evidence that the corresponding figures meet the requirements of the financial reporting framework.
- (ii) When the comparatives are presented as corresponding figures, the auditor's report should not specifically identify comparatives because the auditor's opinion is on the current period financial statements as a whole, including the corresponding figures.
- (iii) When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification in the audit report is:
 - (a) unresolved and results in a modification of the auditor's report regarding the current period figures, the auditor's report should also be modified regarding the corresponding figures; or
 - (b) unresolved, but does not result in a modification of the auditor's report regarding the current period figures, the auditor's report should be modified regarding the corresponding figures.

In such circumstances, the auditor should examine that appropriate disclosures have been made or if appropriate disclosures have not been made, the auditor should issue a modification report on the current period financial modified with respect to the corresponding figures included therein.

- (iv) When the prior period financial statements are not audited, the incoming auditor should state in the auditors report that the corresponding figures are unaudited.
 - (b) Foreign Currency Monetary Items and its Treatment on Balance Sheet date: As per AS- 11 on "Accounting for the Effects of Changes in Foreign Exchange Rates" monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money, e.g., cash, receivable, payables, etc. Regarding foreign currency transactions, AS 11 requires that while reporting effects of changes in exchange rates subsequent to initial recognition, at each balance sheet date, monetary items denominated in a foreign currency, (e.g., foreign currency notes, balances in bank accounts denominated in a foreign currency, and receivables, payables and loans denominated in a foreign currency) should be reported using the closing rate prevailing on balance sheet date. However in certain circumstances the closing rate may not reflect, with reasonable accuracy, the amount in reporting currency that is likely to be realized from or required to be disbursed to because the rate is unrealistic. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realized from or required to be disbursed to at the balance sheet date.
2. (a) Subsequent Events: Accounting Standard- 4 on "Contingencies and Events Occurring After the Balance Sheet Date" deals with all those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors of the company. As per AS 4, those events can be identified as adjustable events, which provide further evidence of conditions that existed at the balance sheet date; and non-adjustable events are those, which are indicative of conditions that arise subsequent to the Balance Sheet Date. AAS 19 (SA 560) on "Subsequent Events" lays down that the "auditor should consider the effect of subsequent events on the financial statements and on the auditor's report". In the instant case, Arya Ltd. had a pending demand of Rs. 26 crores made by the Excise Department for which appeal was made in the Supreme Court. Since the issue involved in the appeal of Arya Ltd. was similar to the point in case of some other company and since the appeal of that company was decided against that company and in favour of the Excise Department, it is necessary for Arya Ltd. to make a provision of Rs. 26 crores. The case settled by the Supreme Court on similar point reflects significant developments affecting the assessment about the potential risk faced by the company. The view of the management that its own appeal is undecided or that it has no effect on the financial position as on 31.03.2006 is not at all tenable. Since the financial position is materially affected, the auditor should express a qualified opinion or an adverse opinion as may be appropriate.
- (b) Disclosure of Earnings Per Share: AS 20 on Earning Per Share (EPS) prescribes principles for the determination and presentation of EPS. As per AS 20, the

earnings per share have to be disclosed as basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share in the net profit for the period. In the instant case, Surya Industries Ltd., both the basic as well as the diluted earnings per share would be the same since there are no dilutive instruments that have been issued by the company. As per AS 20, in the case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration and thus would lead to increase in number of equity shares without any adjustment to outstanding capital amount. Therefore, the number of equity shares outstanding is increased without an increase in resources. The standard further requires that the number of equity shares outstanding before the event of a bonus issue to be adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. Hence the EPS calculated as on 31-03-2006 would be Adjusted EPS and the same would be disclosed. In view of the above, the EPS will be calculated as under:

As on 31.03.2006	Profits	=	Adjusted EPS
	Adjusted No. of Shares		
	$\frac{10,00,00,000}{4,00,00,000}$	=	Rs. 2.5
As on 31.03.2007	Profits	=	EPS
	No. of shares		
	$\frac{15,00,00,000}{4,00,00,000}$	=	Rs. 3.75

Since the above figures of EPS have not been disclosed, Surya Industries Ltd. has not complied with the provisions of AS 20. Therefore, the auditor would have to qualify his report in terms of section 227(3)(d) of the Companies Act, 1956.

- (c) **Validity of Management Representation:** The physical verification of fixed assets is the primary responsibility of the management. The auditor, however, is required to examine the verification programme adopted by the management. He must satisfy himself about the existence, ownership and valuation of fixed assets. In the case of Mohan Ltd., the auditor has not been able to verify the existence and value of some machinery despite the verification procedure followed in routine audit. He accepted the certificate given to him by the management without making any further enquiry. As per AAS 11(SA 580), when representation relate to matters which are material to the financial information, then the auditor should seek corroborative audit evidence for other sources inside or outside the entity. He should evaluate whether such representations are reasonable and consistent with other evidences and should consider whether individuals making such representations can be expected to be well informed on the matter. "Representation by Management"

cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. 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. Therefore, the approach adopted by the auditor is not right.

- (d) **Related Party Transactions:** Accounting Standard 18 and AAS 18 (SA 550), "Related Party Disclosures" applies to the facts of the case. AS 18 requires disclosure of party relationship and transactions between a reporting enterprise and its related parties. The parties are considered to be related if at any time during the reporting period, one party has the ability to control the other party or exercise significant influence over the other party in making decisions. As per the explanation given in AS 18, significant influence is said to exist in case the investing party has 20% or more voting power in the enterprise. In the instant case, the managing director of XYZ Ltd. is a partner in the firm with his son, which has been paid Rs. 2 lakhs as job work charges. The managing director is having a substantial holding in the firm. The case is squarely covered by AS 18. The approach of the managing director is not tenable under the law and accordingly all disclosure requirements have to be complied. Accordingly, the approach followed by the Managing Director is not right. Under the circumstances, the auditor shall have to modify his report. Also it has to be seen whether Section 299 regarding disclosure of interest by interested directors has been complied with. If it is not complied with, the auditor needs to modify the report appropriately.
- 3. (a) **Creation of Deferred Tax Asset:** Accounting Standard 22 on "Accounting for Taxes" requires that Deferred Tax Asset (DTA) should be recognised for all timing differences, subject to the considerations of prudence. The Standard further states that unabsorbed losses of the business can be considered for creation of DTA provided there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such DTA can be realised. In view of this, the DTA created by the CFO of Shakti Pan Masala (P) Ltd. is not in order. Since the company which is in the business of manufacturing of panmasala has been incurring heavy losses and in addition to this the State in which the company is having its major sales is proposing the ban on sale and manufacture of pan masala, the statutory auditor would, therefore, have to qualify his report and mention the extent of amounts of loss and reserves which are under and overstated respectively.
- (b) **Capitalisation of Interest:** As per AS 13 on "Accounting for Investments", the cost of investment includes acquisition charges such as brokerage, fees and duties. In the instant case, Big Ltd. has used borrowed funds for purchasing shares of its subsidiary company Small Ltd. Rs. 4 lakhs interest payable by Big Ltd. to State

Bank of India can not be called as cost of investment. The Accounting Standard 16 on "Borrowing Costs" also does not consider investment in shares as qualifying asset that can enable a company to add the borrowing costs to investments. In the instant case, the statutory auditor would qualify his report by stating that the borrowing costs have been wrongly added to the cost of investments rather than charging them to profit and loss account. The effect of the same on the profits for the year would also have to be mentioned.

4. (a) Evaluation of Internal Audit Function: The external auditor should as a part of his audit, carryout general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor. As per AAS 7 (SA 610) "Relying Upon the Work of an Internal Auditor", the important aspects to be considered by external auditor are:
- (i) Organisational Status: An important aspect is whether the audit is being carried out by outside agency or by departmental team. Another related aspect is level in the organisation to whom the report is addressed and whether he is free to communicate with the external auditor.
 - (ii) Scope of Function: Nature and depth of coverage of the internal audit and to what extent the management considers and where appropriate, act upon the recommendations of the internal auditor.
 - (iii) Technical competence: Internal audit work is performed by persons having adequate technical training and proficiency. Professional qualification and experience of the persons carrying out internal audit function also need to be considered.
 - (iv) Due Professional care: It should be ascertained that the internal audit appears to be properly planned, supervised, reviewed and documented. Existence of proper internal audit manual, programmes and working papers will lead to the establishment of due professional care.

The external auditor should document his evaluation and conclusion of all the above factors.

- (b) Compilation of Financial Information: According to AAS 31(SA 4410) "Engagements to Compile Financial Information", an accountant would normally have to rely upon the management for information to compile the financial statements in a compilation engagement. If in the course of compilation of financial statements, it is observed that the information supplied by the entity is incorrect, incomplete or otherwise unsatisfactory, the accountant should perform following procedures:
- (i) Make any enquiries of management to assess the reliability and completeness of the information provided;
 - (ii) Assess internal controls prevailing in the entity; and

(iii) Verify any matters or explanations.

The accountant may also request the management to provide additional information. This may be asked in the form of management representation letter. If the management refuses to provide additional information, the accountant should withdraw from the engagement, informing the entity of the reasons for such withdrawal.

If one or more accounting standards are not complied with, the same should be brought to the notice of the management and if the same is not rectified by the management, the accountant should include the same in notes to the accounts and the compilation report to the management.

5. **Cut-off Procedures:** Cut-off procedures mean procedures employed to ensure the separation of transactions at the end of one year from those in the commencement of the next year. Usually, the problem of overlapping is found in inventory accounting since quite often goods are sold but passed on to the buyer only after the year is over or goods are bought but received only after the close of the year. This situation may create considerable problem for the proper stock taking of inventory. Therefore, the principal areas of application of cut-off procedures involve sales, purchases and stock. The auditor should satisfy himself by examination and test check that these procedures adequately ensure that:
 - (a) Goods purchased for which property has passed to the client have in fact been included in inventories and that the liability if any, has been provided for.
 - (b) Goods sold have been excluded from the inventories and credit, has been taken for sales.

The auditor may examine a sample of documents evidencing the movement of stocks into and out of stores, including documents pertaining to period shortly before and shortly after the cut-off date, and check whether the stocks represented by those documents were included or excluded, as appropriate, during the stock-taking.

6. **Surprise Checks:** The AAS 6 (SA 400), "Risk Assessment and Internal Control", prescribes that "the auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level." The understanding of the accounting and internal control system can be obtained in several ways including inspection of documents making inquiries of appropriate management, observation of activities, etc. It is in this context, surprise checks intend to ascertain whether the system of internal control is operating effectively and whether the accounting and other records are prepared concurrently and kept up-to-date. Particularly, the observation of the entity's activities and operations including observation of the

organisation of computer operations, personnel performing control procedures and the nature of transaction processing on a surprise visit would reveal the exact manner in which the activities are being performed in the manner prescribed by the management. It has often been found that manipulations and frauds are facilitated under a system of book-keeping, which does not give proper emphasis to the need to keep the books up-to-date. Errors in book-keeping are often indicative of weaknesses in internal control which may be taken advantage of in order to perpetrate frauds or manipulations. Surprise checks are a useful method of determining whether or not such errors exist and where they exist, of bringing the matter promptly to the attention of the management so that corrective action is taken immediately. Consequently, surprise visits by the auditor can exercise a good moral check on the client's staff.

The Guidance Note issued by the Institute on the subject specifies that surprise checks are a part of the normal audit and the results of such checks are therefore important primarily to the auditor himself in deciding the scope of his audit and submitting his report thereon. The need for and frequency of surprise checks is obviously a matter to be decided having regard to the circumstances of each audit. It would depend upon the extent to which the auditor considers the internal control system as adequate, the nature of the clients' transaction, the locations from which he operates and the relative importance of items like cash, investments, stores etc. However, wherever feasible a surprise check should be made at least once in the course of an audit. If this surprise check reveals any weaknesses in the system of internal control or any fraud or error or the fact that any book or register has not been properly maintained or kept up-to-date, the auditor should communicate the same to the management and ensure that action is taken on the matters communicated by him. It does not necessarily follow that all or any of the matters communicated to the management should form part of the auditor's report on the accounts. Thus "surprise checks" help the auditors, during the course of their audit, to ascertain whether the internal control is operating effectively in a company or not.

7. Flow-chart technique for evaluation of internal control: A flow-chart is a graphic presentation of the flow of transactions and documents in an organisation. Evaluation of the internal controls forms an important part of the auditing process as it enables the auditor to know the weaknesses and strengths of the accounting system and consequently the general reliability of the accounting records and data emanating therefrom. Also, it helps the auditor to decide upon the relative audit thrust needed in the different accounting areas. A properly drawn up flow chart can provide a neat visual picture of the whole activities of the section or department involving flow of documents and activities. More specifically it can show:

- (i) at what point a document is raised internally or received from external sources;

- (ii) the number of copies in which a document is raised or received;
- (iii) the intermediate stages set sequentially through which the document and the activity pass;
- (iv) distribution of the documents to various sections, departments or operations;
- (v) checking authorisation and matching at relevant stages;
- (vi) filing of the documents; and
- (vii) final disposal status.

Different methods are available with the auditor to evaluate the internal controls but the flow-charting method is, perhaps, the most scientific and advantageous as compared to other methods. It provides the most concise but comprehensive way of recording the operating controls along with the flow of transactions and documents. In the flow-chart, a total and complete visual picture and control system is available and as such its reception in the human mind is direct. In drawing a flow-chart, organised and concentrated application of mind is essential to reflect the control system in a rational manner. Even in a large and complex organisation, the control system could be depicted by few sheets of neatly drawn flow-charts. However, in drawing the flow chart, the auditor has to take few precautions, e.g., flow-charts should not be lengthy and cumbersome, should be neat, should portray the flow completely with final disposal of papers and there should be proper use of symbols and lines. The auditor will be able to visually correlate the functions and the related controls and assess the adequacy and effectiveness thereof much quickly than a possibly in any other method.

8. **Reporting of Personal Expenses of Directors:** Section 227 of the Companies Act, 1956, specifies the reporting requirements on the part of an auditor.

Under clause (e) of Section 227(1A) of the Companies Act, 1956, the auditor has to make a specific inquiry whether any personal expenses have been charged to revenue account. The charging to revenue of such personal expenses, either on the basis of the company's contractual obligations, or in accordance with accepted business practice, is perfectly normal and legitimate and does not call for any special comment by the auditor. Where, however, personal expenses not covered by contractual obligations or by accepted business practice are incurred by the company and charged to revenue account, it would be the duty of the auditor to report thereon. If no such expenses are found, the auditor has no further duty to report that he is so satisfied. However, he would have to keep in his working papers adequate documentation that he had made such inquiries. Further, Under para 4(A)(xix) of the MAOCARO, 1988 issued under Section 227(4A) of the Companies Act, 1956 the auditor has also to report whether any personal expenses have been charged to revenue account and, if so, the details thereof have to be mentioned. Reporting under this clause is mandatory even if there are no personal

expenses which have been charged to revenue. Though the requirement under Section 227(1A) involved making an enquiry but the MAOCARO, 1988 extended this requirement that an auditor would not only make an enquiry but also report whether or not any personal expenses have been charged to revenue account. In most cases, however, the report under this clause generally states that no personal expenses have been charged except those payable under contractual obligations or in the normal course of business. Where, however, such expenses are not covered by contractual obligations or generally accepted business practice and are charged to revenue account, the auditor shall have to report in respect of such expenses.

9. Section 217 of the Companies Act, 1956 specifies the contents to be included in the Board of Directors' report and states that there shall be attached to every balance sheet laid before a company in general meeting, a report by its Board of Directors, with respect to:
- (i) the state of the company's affairs;
 - (ii) the amounts, if any, which it proposes to carry to any reserves in such balance sheet;
 - (iii) the amount, if any, which it recommends should be paid by way of dividend;
 - (iv) material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the financial year of the company to which the balance sheet relates and the date of the report;
 - (v) conservation of energy, technology absorption, foreign exchange earnings and outgo, in such manner as may be prescribed.

The Board's report shall also contain the material aspects relating to appreciation of the state of company's affairs and deal with important changes. The Board shall also be bound to give the fullest information and explanation in its report aforesaid, or in case falling under the proviso to Section 222, in an addendum to that report, on every reservation, qualification or adverse remark in the auditors' report.

Section 227 of the Act states that it is the duty of an auditor to make a report to the members of the company on the accounts examined by him on every balance sheet and profit and loss account, and every other document declared by this Act to be part of annexed to the balance sheet or profit or loss account which are laid before the company in general meeting during his tenure of office. Thus, as per section 227, the auditor is required to report only on those documents which are part of or annexed to the Balance Sheet and Profit and Loss Account. The subject matter of the auditor's report is the books of account and the financial statements including notes thereon and any other documents annexed thereto and not the Board's Report which as per Section 217 is attached to balance sheet.

Section 222 of the Act dealing with construction of reference to documents annexed to accounts also makes it clear that Board's report is attached to the annual accounts. Therefore, normally the auditors' report does not cover authentication of various matters contained in the Board's report. This is despite the fact that the Board's report contains many matters as stated above, having a bearing on accounts and financial position of the company. For example, the amount of proposed dividend, amount of depreciation, the net profit before tax and net profit after tax are common items that are contained in the Board's report.

However, proviso to Section 222 requires that if any information which is required by this Act to be given in the accounts, and is allowed by it to be given in a statement annexed to the accounts, may be given in the Board's report instead of in the accounts; and if any such information is so given, the report shall be annexed to the accounts and this Act shall apply in relation thereto accordingly, except that the auditors shall report thereon only in so far as it gives the said information.

10. (i) **Decision Tree:** A decision tree is a graphic display of the relationship between the present position and future events; future events and their consequences. The sequence of events is mapped out over time in a format similar to the branches of a tree. The decision tree approach gets its name because of the resemblance with a tree having number of branches. A decision tree represents a decision problem as a series of decisions to be taken under conditions of uncertainty. A present decision depends upon the past decision and their outcomes. The decision trees are the diagrams that permit the various decision alternatives, their outcomes and probabilities of their occurrences to be mapped in a clear fashion.

In a typical decision tree, therefore, the project is broken down into clearly defined stages, and the possible outcomes at each stage are listed along with the probabilities and cash flows effect of each outcome. Important steps while constructing a decision tree in respect of an investment proposal are: definition of the investment proposal, identification of decision alternatives, identification of decision points, chance of events and other data, location on the decisions tree branches of the relevant data such as projected cash flow, expected present value, and selection of the best alternatives. This approach is extremely useful in handling sequential investments and working backwards, eliminating unprofitable branches and determination of optimum decision at various decision points.

The major advantage of a decision tree is that it brings out the implicit assumptions and calculations for all to see, raise questions and revise. It also allows a decision maker to visualise assumptions and alternatives in the graphic form which are easy to understand. The disadvantages, however, are that the diagram becomes complicated and cumbersome as more and more variables are added. The addition

of interdependent alternatives and variables does not only present a queer picture but also makes calculation time consuming.

- (ii) **Utility Routines:** Utility Routines are generally supplied by the computer manufacturer and are available for call up by the operating system. These routines play a key role in an electronic data processing. These are generalised programmes that perform necessary but routine jobs in a computer installation. These routines are sufficiently flexible to handle needs of all users. They are controlled by parameters to indicate the particular characteristics of the data or the requirements. Generally, three types of utility routines are made available by computer vendors.

Data set utilities are used to manipulate files of stored data. One data set utility programme might merge or combine data from more than one file of stored data. Another might copy a file of data to another file. A third might instruct the computer to print selected portions of a set of data. A fourth might sort file records into a desired sequence.

System utilities are used to simplify the task of knowing where data are stored in a computer file. One utility routine might add data to a file, name the set of data, and catalogue the data set to distinguish it from other data sets. Another utility routine might list the catalogue of data sets, showing where particular data is stored in a file. A third might label magnetic tapes. A fourth might accumulate and report errors incurred during the processing of magnetic disk and tape.

Independent utilities perform such housekeeping functions as preparing a back up copy of the contents stored on a magnetic disk file or analysing a magnetic disk for defective tracks. This type of a utility routine performs the needed diagnostic tests.

- 11. **Abnormal Wastage of Raw Material:** The rate of wastage in September, 2007 has risen sharply as compared to previous months. Under the circumstances, before setting for detailed investigation, the internal auditor need to understand the manufacturing environment right from the stage of purchase of materials, the movement of stock flow through the production process while its becomes finished goods. To locate the reasons for the abnormal wastage, the internal auditor should first of all assess the general requirements as under:
 - (i) Procure a list of raw materials, showing the names and detailed characteristics of each raw material.
 - (ii) Obtain the standard consumption figures, and ascertain the basis according to which normal wastage figures have been worked out. Examine the break up of a normal wastage into that in process, storage and handling stages. Also obtain control reports, if any, in respect of manufacturing costs with reference to predetermined standards.

- (iii) Examine the various records maintained for recording separately the various lots purchased and identification of each lot with actual material consumption and for ascertaining actual wastage figures therein.
- (iv) Obtain reports of Preventive Maintenance Programme of machinery to ensure that the quality of goods manufacture is not of sub-standard nature or leads to high scrappage work.
- (v) Assess whether personnel employed are properly trained and working efficiently.
- (vi) See whether quality control techniques have been consistent or have undergone any change.
- (vii) Examine inventory plans and procedures in report of transportation storage efficiency, deterioration, pilterage and whether the same are audited regularly.
- (viii) Examine whether the basis adopted for calculating wastage for September is the same as was adopted for the other three months.
- (ix) Obtain a statement showing break up of wastage figures in storage, handling and process for the four months under reference and compare the results of the analysis for each of the four months.

Some specific reasons for abnormal wastage in process specific may be considered by the auditor are as under:

- (a) Examine laboratory reports and inspection reports to find out if raw materials purchased were of a poor quality or were of sub-standard quality. This will be most useful if it is possible to identify the wastage out of each lot that has been purchased.
- (b) Machine breakdown, power failure, etc. may also result into loss of materials in process. Check the machine utilisation statements.
- (c) A high rate of rejections in the finished lots may also be responsible for abnormal wastage; therefore, examine the inspectors' reports in respect of inspection carried out on the completion of each stage of work or process.
- (d) It is possible that the wastage may have occurred because the particular lot out of which issues were made in September, 2007 was lying in the store for a long time, leading to deterioration in quality or because of a change in the weather which may have led to the deterioration. Compare the wastage figures of September, 2006 with those of September, 2007.
- (e) Abnormal wastage in storage and handling may arise due to the following reasons:
 - (i) Write offs on account of reconciliation of physical and book stocks: In case of periodical physical stock taking, such write offs will be reflected only in the month such reconciliation takes place.

- (ii) Accidental, theft or fire losses in storage: The auditor should examine the possibility of these for the purpose.
 - (f) Examine whether any new production line was taken up during the month in respect of which standard input-output ratio is yet to be set-up.
- 12. Section 22 of the Chartered Accountants Act, while defining professional misconduct, has stated that any act or omission specified in the schedules is professional misconduct. However, the acts or omissions included in the schedules are not exhaustive and any other act or omission also may be deemed as professional misconduct within the meaning of Section 22 of the Chartered Accountants Act.

The First Schedule has three parts while the Second Schedule has two parts. Part I of the First Schedule deals with the misconduct of a member in practice. Part II of this schedule, deals with the conduct of members in service and Part III of the schedule deals with the misconduct of members generally. The offences covered in various parts of the First Schedule are to be adjudicated by the Council of the Institute but the Council's decision may be appealed against. Part I of the Second Schedule deals with misconduct of members in practice while the other part is devoted to misconduct of members generally. The offences covered by the Second Schedule are to be adjudicated by the High Court.

The First Schedule essentially covers independence and conduct of members vis-à-vis co-professionals and other professionals in the first part. Integrity and trustworthiness are the principal elements in the Second Part; falsity, misrepresentation and responsibility to the Institute are the ingredients of the Third Part. In the first part of the Second Schedule, the emphasis is on performance of the professional assignments and the second part deals with compliance with the Chartered Accountants Act and Regulations.

Whether members in service are liable to disciplinary action and, if so, under what circumstances: Members in service are liable to disciplinary proceedings under Part II and III of the First Schedule and under Part II of the Second Schedule. The circumstances are as under:

Part II of the First Schedule:

- (a) If he pays or allows or agrees to pay directly or indirectly to any person share in the emoluments of the employment undertaken by the members.
- (b) If he accepts or agrees to accept any part of fees, profit or gains from a lawyer, chartered accountant or broker engaged by his company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.
- (c) If he discloses confidential information acquired in the course of his employment except as and when required by law or except as permitted by the employer.

Part III of the First Schedule:

- (a) If he includes in any statement, return or form to be submitted to the Council any particulars knowing them to be false.
- (b) If he, not being a Fellow, styles himself as a Fellow.
- (c) If he does not supply the information called for, or does not comply with the requirements asked for, by the Council or any of its Committees.

Part II of Second Schedule:

- (a) If he contravenes any of the provisions of the Chartered Accountants Act or the Regulations made thereunder.
 - (b) If he is guilty of such other act or omission as may be specified by the Council in this behalf by Notification in the Gazette of India.
13. Advantages of Cost Audit to Government: Cost auditor's approach is to ensure that the cost accounting plan is in consonance with the objectives set by the organisation and the system of accounting is geared towards the attainment of the objectives. A cost accounting system designed to exercise control over cost may be different from the one if the objective is to fix price. Accordingly, over a period of time particularly in view of administered pricing system the cost accounting becomes quite important. Some of the specific advantages which can be reaped by the Government are:
- (i) It helps in the fixation of selling prices of essential commodities and thereby avoiding undue profiteering.
 - (ii) In the case of cost plus contracts of Government, it helps to fix the price at reasonable level.
 - (iii) It enables the Government to focus the attention on inefficient units.
 - (iv) It enables the Government to lay down policies in favour of protecting certain industries.
 - (v) It facilitates the settlement of disputes brought to the Government.
 - (vi) It creates healthy competition in the industry.
14. Compliance with SLR Requirements: The Reserve Bank of India requires statutory central auditors of banks to verify the compliance with SLR requirements of 12 odd dates in different months of a financial year not being Fridays. The resultant report is to be sent to the management of the bank and to the Reserve Bank. To verify compliance with SLR requirements, the statutory auditor has to examine two aspects:-
- (i) The correctness of the figure of the demand and time liabilities in India (DTL) at the close of business on the reporting Friday relevant to the dates selected by the auditor, and

- (ii) Maintenance of prescribed percentage of liquid assets on the selected data considering the DTL position on the relevant reporting Friday.

Special points to be noted are:

1. Obtain an understanding of the relevant circumstances of the RBI, particularly regarding composition of items of DTL.
2. Require the branch auditors to verify the correctness of the trial balances relevant to the 12 dates selected by him. The branch auditors should also be specifically requested to examine the cash balance at the branch on the selected dates. The DTL position to be examined will be as on the last Friday of the Second preceding fortnight, i.e., April 11. The position of cash, gold and approved securities shall be as of May 1.
3. Review the relevant returns/received from un-audited branches to identify any obvious errors or omissions or inconsistencies.
4. Examine, on a test basis, the consolidations regarding DTL position prepared by the bank with reference to the related returns received from branches. The auditor should examine whether demand liabilities comprise only those liabilities that must be met on demand.
5. Specifically examine the following items have been excluded from liabilities.
 - ◆ Amount received from deposit insurance and export credit guarantee corporations (ECGC) towards claims in respect of guarantees involved and held pending adjustment of the same towards the related advance.
 - ◆ Amounts received from Court Receiver.
 - ◆ Amount received from insurance companies as a result of "excess claims".
 - ◆ Part amount of recoveries received from the borrowers.
 - ◆ Amounts received in Indian currency against import bills and held in sundry deposits pending receipt of final notes.
 - ◆ Unadjusted deposit/balances lying in link branches for agency business like dividend warrants, interest warrant, refund of application money.
6. Specifically examine that the following items have been included in liabilities
 - ◆ Net credit balance in Branch adjustment accounts including these relating to foreign branches.
 - ◆ Interest on deposit as at the end of the firm half year reversed in the beginning of the next half-year.
7. Verify that in computation of liquid assets, the following are treated as cash.
 - ◆ The deposit maintained with RBI by a banking company incorporated outside India under section 11(2) of the Banking Regulation Act.

- ♦ Any balances maintained by a scheduled bank with the Reserve Bank in excess of the balance required to be maintained by it under section 42 of the Reserve Bank of India Act.
8. Test check the relevant records to verify the amount of unencumbered approved securities held by the bank on the selected dates. Examine whether the valuation of approved securities has been done with reference to cost price, market price, book value or face value or a combination of these methods as may be specified by the Reserve Bank of India from time to time.
15. Verification of Re-insurance outward:
1. Verify that re-insurance underwriting returns received from the operating units regarding premium, claims, paid, outstanding claims, tally with the audited figures of premium claims paid and outstanding claims.
 2. Check whether the pattern of re-insurance underwriting for outward cessions fits within the parameters and guidelines applicable to the relevant year.
 3. Check whether cessions have been made as per the stipulation applicable to various categories of risk.
 4. Verify whether the cessions have been made as per the agreements entered into with the various companies.
 5. See whether the outward remittances to foreign re-insurance have been done as per the foreign exchange regulations.
 6. Ascertain whether the commission has been calculated as per the terms of the agreement with the re-insurance.
 7. Verify the computation of profit commission by various treaty arrangements in the figure of the periodical accounts rendered and in relation to outstanding less pertaining to the treaty.
 8. Examine whether the cash loss recoveries have been claimed and accounted on a regular basis.
 9. Verify whether the claims paid items appearing outstanding claims list by ever. This can be verified at least in respect of major claims.
 10. See whether provisioning for outstanding losses recoverable on cessions have been confirmed by the re-insurers and in the case of major claims, documentary support was insisted and verified.
 11. Accounting aspects of the re-insurance cession premium commission recoverable, paid claims recovered and outstanding losses recoverable on cessions have to be checked.
 12. Check percentage pattern of gross to net premium, claim paid and outstanding claim to ensure comparative justifications.

16. The change in the method of valuation of stock is not a change in method of accounting, as it is only a change in accounting policy. However in the Income Tax Act, 1961 this is considered under method of accounting. Under the Income-Tax Act, 1961 if the change in method of valuation is bonafide, and is regularly and consistently adopted in the subsequent years as well, such change would be permitted to be made for tax purposes. In the instant case, the change in the valuation of stock from LIFO basis to FIFO basis is pursuant to mandatory requirements of the AS-2 'Valuation of Inventories' and therefore should be viewed as bonafide change.

This apart, the tax auditor in his report has to specifically refer to the method of valuation of stock under Clause 12 in Form 3CD.

- (a) Method of valuation of closing stock employed in the previous year.
- (b) Details of deviation, if any, from the method of valuation prescribed under section 145A and the effect thereof on profit or loss.

The auditor has to see that the method of stock valuation is followed consistency from year to year. It is also necessary to ensure that method followed for valuation of stock results in correct profits or gain 2001. The change from LIFO to FIFO is bonafide, the disclosure of which would have to be made in the financial statements. As far as section 145A is concerned, the tax auditor need not change the method of valuation of purchases, sales and inventories which is regularly employed by the assessee. All that he has to do is to adjust the valuation for any tax, duty, cess or fee actually paid or incurred by the assessee, if the same had not already been adjusted.

17. Environmental Audit: Environmental reporting deals with the disclosure by an entity of environmentally related data, regarding environmental risks, environmental impacts, policies, strategies, targets, costs, liabilities or environmental performance to those who have an interest in such information as an aid to enabling/enriching their relationship with the reporting entity via either the annual report; a stand-alone corporate environmental performance report; or some other medium (e.g. staff newsletter, video, CD ROM, internet site). The reports that are generated after such audits can be either compliance-based reporting or impact-based performance reporting.

Environmental audit deals with verification of information contained in such reports with a view to expressing an opinion thereon. Environmental audit can be performed by external agencies or internal experts (including internal auditors). In practice, environmental audit is not done by a single agency but by various agencies who are experts in the field. Since the subject matter of environmental audit involves multi-disciplinary knowledge and skill, it is preferable to form a team of persons drawn from different disciplines who may assist the chartered accountant in performing the task in an effective manner, generally environmental audits are not required by any statute but are

sometimes done at the request of the management to address issues like compliance with environmental laws and regulations, etc.

18. **Auditor's Liability in case of Unlawful Acts or Defaults by Clients:** The auditor's basic responsibility is to report whether in his opinion the accounts show a true and fair view and in discharging his responsibility he has to see as to how the particular situations affected his position. The general thinking with regard to unlawful acts or defaults by clients appears to be that the auditor should not 'aid or abet' but he is apparently not under any legal obligation to disclose the offence. A professional accountant would himself be guilty of a criminal offence if he advises his client to commit any criminal offence or helps or encourages in planning or execution of the same or conceals or destroys evidence to obstruct the course of public justice or positively assists his client in evading prosecution. A professional accountant in his capacity as auditor, accountant, or tax representative has access to a variety of information concerning his clients. On some occasions, he may acquire knowledge that his client has been guilty of some unlawful act, default, fraud, or other criminal offence. The duty of the professional accountant in such a case would depend upon the actual circumstances of the situation. Due consideration should be given to the exact nature of services that a professional accountant is rendering to his client, i.e. is he representing the client in income-tax proceedings or is he acting in the capacity of an auditor or an accountant or a consultant.

The Institute of Chartered Accountants of India has considered the role of chartered accountants in relation to taxation frauds by an assessee and has made the following major recommendations:

- (i) A professional accountant should keep in mind the provisions of Section 126 of the Evidence Act whereby a barrister, an attorney, a pleader or a Vakil is barred from disclosing any communication made to him in the course of and for the purpose of his employment.
- (ii) If the fraud relates to past years when the accountant did not represent the client, the client should be advised to make a disclosure. The accountant should also be careful that the past fraud does not in any way affect the current tax matters.
- (iii) In case of fraud relating to accounts examined and reported upon by the professional accountant himself, he should advise the client to make a complete disclosure. In case the client refuses to do so, the accountant should inform him that he is entitled to dissociate himself from the case and that he would make a report to the authorities that the accounts prepared or examined by him are unreliable on account of certain information obtained later. In making such a report, the contents of the information as such should not be communicated unless the client consents in writing.

- (iv) In case of suppression in current accounts, the client should be asked to make a full disclosure. If he refuses to do so, the accountant should make a complete reservation in his report and should not associate himself with the return.

However, it can be argued that the auditor has a professional obligation to ensure that the client is fully aware of the seriousness of the offence and to seriously consider full disclosure of the matter.

It has been clearly established in various case laws that the auditor is expected to know the contents of documents and records and ascertain whether the affairs of the client are being conducted in an unlawful manner. It is in the course of the work, he comes across any unlawful acts, it is his duty to bring it to the notice of the client as also to make a disclosure in his report in appropriate cases. In this regard, one has to bear in mind the consequence of the act in relation to the professional code to which an auditor is subjected. Under the code, an auditor cannot disclose confidential information unless permitted by the client or unless required by law. Each case has to be judged on its circumstances. However, in every case he has to assess the implications of the unlawful act or default on the true and fair character of the accounting statements.

The question of liability of an auditor for unlawful acts or defaults by clients should be considered in the light of the broad parameters given above. However, it appears that if an auditor was aware of any unlawful act having been committed by client in respect of accounts audited by him and the unlawfulness was not rectified by proper disclosure or any other appropriate means, the auditor owes a duty to make a suitable report. If he does not, he may be held liable, if the true and fair character of the accounts has been vitiated.

19. Other Misconduct: A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, 1949 if he is found guilty of any professional or "Other Misconduct". "Other Misconduct" has not been defined in the Act. This provision empowers the Council to inquiry into any misconduct of a member even if it does not arise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards, even in his non-professional work, would expose him to disciplinary action. For example, a member who is found to have forged the will of a relative, would be liable to disciplinary action even though the forgery may not have been done in the course of his professional duty. Other misconduct would also relate to conviction by a competent court for an offence involving moral turpitude punishable with cause transportation or imprisonment to an offence not of a technical nature committed by the member in his professional capacity.

In the absence of a statutory definition of "other misconduct", the question whether a particular act or omission constitutes "other misconduct" has to be decided on the facts and circumstances of each case. In this context, the judgement of the Supreme Court in

“Council of the Institute of Chartered Accountants of India and another vs B. Mukherjee” reported in Disciplinary Cases Volume III (page 413 to 422) acquires special significance. After examining the nature, scope and extent of the disciplinary jurisdiction, which can be exercised under the provisions of the Act, the Supreme Court observed as under:

“We therefore, take the view that, if a member of the Institute is found, *prima facie*, guilty of conduct, which, in the opinion of the Council renders him unfit to be a member of the Institute, even though such conduct may not attract any of the provision of the Schedules, it would still be open to the Council to hold an inquiry against the member in respect of such conduct and a finding, against him, in such an inquiry, would justify appropriate action being, taken by the High Court”.

Some illustrative examples, where a member may be found guilty of “Other Misconduct”, under the aforesaid provisions rendering, himself unfit to be member are:

- (i) Where a chartered accountant retains the books of account and documents of the client and fails to return these to the client on request without a reasonable cause.
 - (ii) Where a chartered accountant makes a material misrepresentation.
 - (iii) Where a chartered accountant uses the services of his articled or audit clerk for purposes other than professional practice.
 - (iv) Conviction by a competent court of law for any offence under Section 8 (v) of the Chartered Accountants Act 1949.
 - (v) Misappropriation by office-bearer of a Regional Council of the Institute, of a large amount and utilisation thereof for his personal use.
 - (vi) Non-replying within a reasonable time and without a good cause to the letter of the public authorities.
20. (a) Section 225(3) of the Companies Act, 1956 permits a retiring auditor to make a representation in writing (not exceeding a reasonable length) to the company. The proposition of the partner to highlight contributions made by the firm in strengthening the control procedures in the representation is not acceptable because the representation letter should not be prepared in a manner so as to seek publicity. The Code of Ethics issued by the Institute makes it amply clear that the right to make representation does not mean that an auditor has any prescriptive right or a lien on an audit. The wording of his representation should be such that, apart from the opportunity not being abused to secure needless publicity, it does not tantamount directly or indirectly to canvassing or soliciting for his continuance as an auditor. The letter should merely set out in a dignified manner how he has been acting independently and conscientiously through the term of office and may, in addition, indicate if he so chooses his willingness to continue as auditor if re-appointed by the shareholders. Thus, such action proposed by a partner could not be approved since, it would lead to his being held guilty of professional misconduct

under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

- (b) Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits solicitation of client or professional work either directly or indirectly by circular, advertisement personal communication or interview or by any other means since it shall constitute professional misconduct. The bio-data was handed over to the chairperson during the T.V. interview by the Chartered Accountant which included details about the firm and the achievements of the partner as an expert in the field of taxation. The chairperson simply read out the same in detail about association with the international firm as also the achievements of the partner and his recognition as an expert in the field of taxation. Such an act would definitely lead to the promotion of the firms' name and publicity thereof as well as of the partner and as such the handing over of bio-data cannot be approved. The partner would be held guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.
- (c) Professional services cannot and should not be offered under an agreement which entails that fees shall be payable on a success fee basis. The fees payable, therefore, become contingent in nature. It is obvious that a person who is to receive payment in direct proportion to the benefit received by his client, may be tempted to exaggerate the advantage of his service or may adopt means which are not ethical. It will have the effect of undermining his integrity and impairing his independence. Therefore, the remuneration based on a percentage of the profits or on the happening of a particular contingency such as, the successful outcome of an appeal in revenue proceedings is prohibited. Therefore, the action of the firm to quote fees in such a manner on the advice of the Chairman of the Audit Committee to ensure their appointment could not be accorded approval and the member would be held guilty of professional misconduct under Clause (10) of Part I of the Chartered Accountants Act, 1949.

In the instant case, the Chairman of Audit Committee who also happens to be a chartered accountant would also be guilty of misconduct under the Chartered Accountants Act, 1949.

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