

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

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

Question 1

Comment on the following:

- (a) You are appointed to compile financial statements of Y & Co. for tax purposes. During the course of work, you learn that the inventory is grossly understated. On pointing the same, the partners of Y & Co. tell you that since you are not conducting an audit, the said figures duly certified by the firm should be accepted. (5 Marks)
- (b) While conducting statutory Audit of ABC Ltd., you come across IOUs amounting to Rs. 2 crores as against a cash balance shown in books of Rs. 2.10 crores. You also observe that despite similar high balances throughout the year, small amounts of Rs. 50,000 are withdrawn from the bank to meet day-to-day expenses. (5 Marks)
- (c) Z Ltd. had appointed an outside expert to assess accrued gratuity liability of the company. Based on the said report, the company provides Rs. 80 lakhs as gratuity in the financial statements. (4 Marks)
- (d) A Company's net worth is eroded and creditors are unpaid due to liquidity constraints. The management represents to the statutory auditor that the promoter's wife is expected to give an unsecured loan to meet the liquidity constraints and that negotiations are underway to secure large export orders. (4 Marks)

Answer

- (a) According to AAS 31 (SRS 4410) "Engagement to Compile Financial Information" "if an accountant becomes aware of material misstatements, the accountant should persuade the management to carry out necessary amendments in the financial statements or other compiled financial information. If such amendments are not made and the financial statements are still considered to be misleading the accountant should withdraw from the engagement. Hence, in this case, there is a clear violation of AAS 31(SRS 4410).
- (b) According to AAS 4 (SA 240) "Auditors responsibility to consider fraud and error in an audit of financial statements", when the auditor comes across such circumstances indicating the possible misstatements resulting from procedure to consider the effect of fraud and error on auditors report. In this case, the circumstances indicate that the possible misstatements in financial statements is due to fraud and error and the auditor must investigate further to consider effect on financial statements.

The Guidance Note on Audit of Cash and Bank balances also mentions that if the entity is maintaining an unduly large balance of cash, he should carry out surprise verification of cash more frequently to ascertain whether it agrees. If cash in hand is not in agreement with the book balance, he should seek explanations and if the same are not satisfactory should state the said fact appropriately in his Audit Report.

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- (c) AAS 9 (SA 620) states that while using the work of an expert, auditor should consider the materiality of the item, nature and complexity of the item, the other audit evidence available and professional qualifications, experience and reputation in the field of the concerned expert.

The auditor should ensure that the expert has used appropriate source data, has made consistent assumptions, has applied correct methods and that results of expert's work are in line with auditor's overall knowledge of the business and match with results of his audit procedures. The auditor should also ensure that substance of expert's findings is properly reflected in the financial information.

- (d) In this case, it is subjective, but prima-facie a mere expectation of future cash flows from the promoter's wife without any firm commitment and the possibility of an export order being negotiated, may not that be sufficient appropriate audit evidence of mitigating factors for resolving the going concerns question under AAS 16 (SA 570) "Going Concern".

Question 2

Comment with reference to the Chartered Accountants Act, 1949 and Schedules thereto:

- (a) H, a Chartered Accountant in practice is a partner in 3 firms. On the personal Letter Heads of H, names/address of all the 3 firms are mentioned. (4 Marks)
- (b) D, who conducts the tax audit u/s 44AB of the Income Tax Act, 1961 of M/s ABC, a partnership firm, has received the entire audit fees of Rs. 25,000 in April, 2009 in respect of the tax audit for the year ended 31.3.2009. The audit report was, however, signed on 25.5.2009. (4 Marks)
- (c) M/s LMN, a firm of Chartered Accountants having 5 partners accepts an audit assignment of a newly formed private limited company for audit fees of Rs. 5,000. (5 Marks)
- (d) P, a Chartered Accountant in practice, accepts appointment as statutory auditor for LMN Pvt. Ltd. Q, brother of P has substantial interest in LMN Pvt. Ltd. (5 Marks)

Answer

- (a) Under clause (7) of part -1 of First Schedule, a CA in practice is deemed to be guilty of professional misconduct if he (i) advertises his professional attainments or services or (ii) uses any designation or expressions other than '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 ICAI or of any other institution that has been recognized by the Central Government or may be recognized by the council.

Here there is no prohibition for printing names of all 3 firms on the personal letter heads in which a member holding certificate of practice is a partner. Thus, H is not guilty of any professional misconduct in the above case.

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- (b) Under section 226(3)(d) of Companies Act, 1956 a person is disqualified from being an auditor if he is indebted to the company for more than Rs. 1,000/-. This provision applies only to an auditor appointed under the Companies Act, 1956.

In the instant Case, D is appointed to conduct a tax audit u/s 44AB of the Income Tax Act, 1961. There is no such similar provisions in the Income Tax Act. Thus, D will still be able to do the audit and would not be disqualified. He also does not violate any provision of the CA Act, 1949 and schedules thereto.

- (c) As per the council general guidelines 2008, the minimum audit fees are prescribed depending on the number of partners in a firm and the city in which the audit is to be carried out. A proviso to the said guidelines states that the restriction does not apply for audit of newly formed concerns for 2 accounting years from the date of commencement of operations.

In the instant case, since the audit assignment is of a newly formed private limited company the proviso shall apply and M/s LMN can conduct the audit without violation of any code of conduct.

- (d) As per clause (4) of part I of II schedule, a CA is deemed to be guilty of professional misconduct if he expresses his opinion on financial statements in which his firm or a partner has substantial interest. As per Council General Guidelines, 2008, the above restriction is also made applicable for relatives of the members.

In the instant Case, since Q, a relative has a substantial interest in LMN Pvt. Ltd, P cannot conduct the audit and will be guilty of misconduct.

Question 3

Answer the following:

- (a) You are appointed statutory auditor of X Ltd. X Ltd. has an internal audit system and reports for the same are given to you. Mention the factors you will consider to ensure that the said system of internal audit of X Ltd. is commensurate with the size of the company and nature of its business. (8 Marks)
- (b) The audit report of P Ltd. for the year 2007-08 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2008-09, how would you report, if:
- (i) The company does not make provision for doubtful debts in 2008-09?
 - (ii) The company makes adequate provision for doubtful debts in 2008-09? (8 Marks)

Answer

- (a) As per AAS 7 (SA 610) "Relying on Work of an Internal Auditor" the statutory auditor has to consider the following before placing reliance on the same".
- (i) Organizational status – whether the same is done internally or by an external agency.
 - (ii) Scope of work – What is the nature and depth of the coverage of the assignment.

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- (iii) Technical competence – Whether the internal auditor is technically competent to do the work i.e. having adequate technical training and proficiency.
- (iv) Due professional care – Whether his work and reports appear to be properly planned, supervised reviewed and documented.

If the above factors are not satisfactory, the statutory auditor will have to modify his audit program and increase the verification to be carried out.

- (b) Auditor's responsibilities in cases where audit report for an earlier year is qualified is given in AAS 25 (SA 710) "Comparative". As per AAS 25 (SA 710), when the Audit Report on the prior period intended a qualified opinion and the said matter is:
 - (i) Unresolved and results in an modification of the auditors report regarding current year's figures, his report should be modified regarding corresponding figures.
 - (ii) Resolved and properly dealt with in the financial statements, the current report should ordinarily not refer to such modification. If however, the matter is material, he may include an "emphasis of matter" paragraph.

In the instant Case, if P Ltd. does not make provision for doubtful debts the auditor will have to modify his report for both current and previous year's figures. If however, the provision is made, the auditor need not refer to the earlier years modification.

Question 4

Answer the following:

- (a) What are the duties of a statutory auditor regarding disqualification of a director u/s 274(1)(g) of the Companies Act, 1956 ? (8 Marks)
- (b) While doing the audit of consolidated Financial Statements, which current period consolidation adjustments are to be taken into account? (8 Marks)

Answer

- (a) As per section 274(1)(g) of the Companies Act, a director is disqualified if :
 - the concerned public company has not filed the annual returns/accounts for any 3 continuous financial years on or after 1-4-1999.
 - the director in such a case becomes disqualified on the last date for filing the above documents. The Auditor should therefore obtain representation for :
 - (i) names of directors for the period.
 - (ii) particulars of appointment/reappointment for above.
 - (iii) whether directors have submitted for DD-A as required by the Rules.
 - (iv) that the information contained in Register of Directors is updated .
 - (v) whether company has committed any default as envisaged above.
 - (vi) if default is committed, whether Form DD-B has been submitted.

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After ascertaining the above, auditor has to report under section 227(3)(f) whether any director has been disqualified and if so, mention the said fact.

- (b) Following are the current period consolidation adjustments while making consolidation of financial statements.
- Elimination of intra-group transactions relating to interest or management fees etc.
 - Elimination of unrealized intra-group profits on assets acquired from other subsidiaries.
 - Elimination of intra-group indebtedness.
 - Adjustments for harmonizing different accounting policies of parent unit and its subsidiaries.
 - Adjustments for impairment loss that might exist for goodwill.
 - Adjustment for significant events that occur between date of financial statements of the parent and of its components when the date/s of financial statements of components are different from the reporting date.
 - Determination of movement in equity attributable to the minorities since the date of acquisition of the subsidiary.
 - Treatment of minority interests' share of the losses, if such losses exceed the minority interests' share in the equity.

Question 5

Answer the following:

- (a) Loans were given out of the funds of an Employees Provident Fund to the employer company in contravention of the applicable rules. As the auditor of the said Provident Fund, M discloses the contraventions to the Trustees of the fund, but failed to do so to the members of the fund. Comment. (5 Marks)
- (b) X Ltd. did not follow the applicable Accounting Standard for disclosing Earnings Per Share (EPS) in the financial statements. The fact of such non-disclosure was however, mentioned in the notes forming part of accounts. As the statutory auditor of X Ltd., how would you report in the above case? (5 Marks)
- (c) What are the considerations to be kept in mind while performing analytical procedures on data prepared by the client. (6 Marks)

Answer

- (a) In the given Case, CA M has contravened clause (5) of part I of Second Schedule to the CA, Act. It is the duty of a CA in practice to disclose material facts known to him so that the financial statement does not become misleading. Further the auditor CA should disclose such facts to beneficiaries of a fund in applicable cases. Technically, appointment of an auditor could be done by a company through its directors, but in substance the auditor in such cases addresses to the beneficiaries just like he gives his

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report to the shareholders of a company. Mr. M is found guilty of professional misconduct.

- (b) Disclosure of EPS is required for all companies as per AS 20 “Earnings per Share”. AS 20 is also one of the AS notified by the Companies (Accounting Standards) Rules, 2006. If the disclosures required by AS 20 are not made, it is the duty of the auditor to qualify in his report “Whether Accounting Standards under the clause as notified u/s 211(3C) have been followed?”. Mere disclosure by company in notes does not absolve him of his duty.

The same is however not a qualification to affect the “True & Fair” position of financial results of the company.

- (c) When the auditor intends to perform analytical procedures on data prepared by the client, he should consider the following:
- Objective of such procedures and the extent to which he may be able to rely on their results.
 - Nature of the entity and the degree to which information can be disaggregated, for example, analytical procedures may be effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
 - Availability of information, both financial, such as budgets or forecasts, and non-financial such as the number of units produced or sold.
 - Reliability of the information available
 - Relevance of the information available
 - Sources of information available
 - Comparability of the information available
 - Knowledge gained by the auditor during previous examinations.
 - Testing the controls over the preparation of non financial information, if any, used in applying analytical procedures.

Question 6

Answer the following:

- (a) List the special features involved in the audit of a Cooperative Society. (8 Marks)
- (b) Draft an Audit programme for conducting the audit of a Public Trust registered under section 12A of the Income Tax Act, 1961. (8 Marks)

Answer

- (a) Following are the special features in the audit of a cooperative society:
- Examination of overdue debts.

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- Special treatment of over due interest in the determination of profit.
 - Certification of bad debts before write off.
 - Valuation of assets and liabilities
 - Adherence to co-operative Principles.
 - Observations of the Provisions of the Act and Rules
 - Verification of members' Register and examination of their pass books
 - Special report to the registrar on fraud, mismanagement and personal profiteering.
 - Audit classification of society based on the audit findings
 - Discussion of draft audit report with the managing committee.
- (b) An auditor should conduct routine checking during the course of audit of a public trust, in the following manner:
- (i) Check the books of account and other records having regard to the system of accounting and internal control
 - (ii) Vouch the transactions of the trust to satisfy that:
 - (a) the transaction falls within the ambit of the trust
 - (b) the transaction is properly authorized by the trustees or other delegated authority as may be permissible in law;
 - (c) all incomes due to the trust have been properly accounted for on the basis of the system of accounting followed by the trust;
 - (d) all expenses and outgoings appertaining to the trust have been recorded on the basis of the system of accounting followed by the trust;
 - (e) amounts shown as applied towards the object of the trust are covered by the objects of trust as specified in the document governing the trust.
 - (iii) Obtain trial balance on the closing date certified by the trustees' duty certified by the trustee;
 - (iv) Obtain Balance Sheet and Profit & Loss Account of the trust authenticated by the trustees and check the same with the trial balance with which they should agree.

Question 7

Answer the following:

- (a) Enumerate the verification procedures in relation to audit of a Hire-Purchase Finance Company. (8 Marks)
- (b) As the tax auditor of a non-corporate entity u/s 44AB of the Income Tax Act, 1961, how would you ensure compliance of section 145 of the Income Tax Act, 1961? (8 Marks)

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Answer

(a) Verification Procedures in relation to audit of a Hire Purchase Finance company (HPFC):

Hire Purchase Finance Company

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

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

- (i) AS (IT)-1: Disclosure of accounting policies.

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

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

- (i) Where the Assessing Officer is not satisfied about the correctness or complete ness of the accounts of the assessee
- (ii) Where the method of accounting has not been regularly followed by the assessee.
- (iii) Where the AS notified u/s 145(2) have not been regularly followed by the assessee.

The auditor has to therefore ensure that:

- (a) the entity follows either the cash or accrual method of accounting
- (b) Accounting policies are required by AS (IT) -1 has been disclosed separately.
- (c) Other provisions of AS 1 (IT) and AS (IT) -2 have been complied with.

Question 8

Answer the following:

- (a) What are the points to be considered while evaluating the "Knowledge of the Business" in the conduct of an audit? (8 Marks)
- (b) Write short notes on:
- (i) Probable format of Environmental Statement. (4 Marks)
- (ii) "Reporting" stage in Peer Review. (4 Marks)

Answer

- (a) Points to be considered while evaluating "Knowledge of the Business" (as per erstwhile AAS 20 which has now been withdrawn):
- (i) Changes in management, organization structure and activities of the client;
- (ii) Legislation charges affecting the business of the client
- (iii) Business developments affecting the client.
- (iv) Existence of related parties with whom business is being conducted by the client
- (v) Changes in technology, production facilities and its effect on profitability
- (vi) Significant matters from earlier years audit reports etc.
- (vii) Changes in internal control systems
- (viii) New facilities and other charges made during the year
- (ix) Relevance of work carried out by internal auditors.

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- (b) (i) Probable format of “Environmental Statement”
 - (a) Name/address of owner/occupier of the industry, operation or process.
 - (b) Date of last environmental audit report submitted
 - (c) Consumption of water and other raw materials as input during current and previous year.
 - (d) Pollution generated in air and water with output and types of pollutants and deviation from standard.
 - (e) Generation of hazardous waste in current year and previous year from processes or from pollution control facility.
 - (f) Quantity of solid waste generated during current year and previous year from process/es from pollution control facility and from recycling or reutilization of waste, etc.
 - (g) The disposal practice for different type waste.
 - (h) The practice of conservation of natural resources.
- (ii) The additional investment proposal for environmental protection including abatement of pollution.
- (iii) Reporting stage in Peer Review: This includes the following steps:
 1. Preliminary Report of Reviewer - At the end of the on-site review, the reviewer is required to send a preliminary report to the practice unit before making any report to the Board on the areas in case systems and procedures of the practice unit reviewed have been found to be deficient or where non-compliance with reference to any other matter has been noticed by the reviewer during the course of review. The reviewer has to take care that the report does not contain name of any individual of the practice unit. However, no preliminary report is required in case no deficiencies or non-compliance are noticed by the reviewer.

The reviewer while preparing the preliminary report should review and assess the conclusions drawn from the review that indicates the deficiencies to be reported upon. The preliminary report is addressed to the practice unit. The report, apart from mentioning the areas where systems and procedures of the practice unit have been found to be deficient, should also contain a paragraph that discusses the scope of the review performed by the reviewer. If the reviewer draws a conclusion that there existed a limitation on scope of review, the fact, along with such limitation on the scope of the review, should also be communicated to the practice unit through the preliminary report. The reviewer should prepare the report on his letterhead. The report should be dated and also contain the reviewer's signature and membership number and reviewer's code number allotted by the Board.

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2. Reply to Preliminary Report - The practice unit has to send its submissions or representations, in writing, to the reviewer, on the areas mentioned in the preliminary report. The reply to the preliminary report should be sent by the practice unit within a period of 21 days from the receipt of the preliminary report from the reviewer.
3. Interim Report of the Reviewer - If the reviewer is not satisfied with the reply of the practice unit, the reviewer has to submit an interim report to the Board. The report so submitted should clearly indicate that it is an "interim report". It may be noted that the Board may then give recommendations to the practice unit and instruct the reviewer to carry out a further review after minimum six months in case of any weakness in the compliance of technical standards is reported by the reviewer or follow up review after twelve months in case of any weakness in the internal control system of the concern is reported by the reviewer and to verify whether the systems and procedures of the practice unit have been modified appropriately. The reviewer is then required to submit a report to the Board.
4. Final Report of the Reviewer - If the reviewer is satisfied with the reply of the practice unit, the reviewer shall submit his final report to the Board. The final report should incorporate the findings as discussed with the practice unit.