PAPER – 3 : ADVANCED AUDITING

*Answer **all** questions.*

Question 1

As an auditor how would you deal with the following?

(a) There is a sales-tax demand of Rs. 3 crores against X Ltd. relating to prior years against which the company has gone into an appeal. (5 marks)

(b) When the audit team visited the client to perform substantive audit of debtors, the client produced ledger accounts of customers and confirmations for the top 10 debtors. One of the debtors was more than 5 years old, but it had confirmed his balance. (5 marks)

(c) A Ltd. prepared an invoice for an export consignment on FOB basis on 30th March, 2010. The goods were dispatched from the factory on 30th March, 2010 and the Bill of Lading was made on 3rd April, 2010. A Ltd. had booked the invoice in the Sales Register for March, 2010. (5 marks)

(d) LMN Pvt. Ltd. is a dealer in government securities. The turnover on account of sale of securities for the year ended 31st March, 2010 is Rs. 85 crores whereas the net profit is Rs. 0.10 crore. While finalizing the accounts, the company did not prepare the Cash Flow Statement. (5 marks)

Answer

(a) As per Paragraph 10 of AS 29 "Provisions, Contingent Liabilities and Contingent Assets", contingent liability is:

(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) a reliable estimate of the amount of the obligation cannot be made.

Accordingly in this case, when there is sales tax demand of Rs. 3 crores and the company has gone in an appeal, it needs considerations as to whether the entire demand is disputed, because it is difficult to presume that the demand by sales tax authority is without any basis. Therefore, partly to the extent the company considered that the demand is based on some logical basis, that amount may be provided for and the remaining may be disclosed as the contingent liability.

However as per Paragraph 4(ix)(b) CARO,2003 "In case dues of Income Tax/ Sales Tax/ Service Tax/ Customs Duty/ Wealth Tax/ Excise Duty/ Cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. A mere representation to the Department shall not constitute the dispute." The auditor should also obtain a management representation about the disputed dues, the amounts involved and the forum where the dispute is pending. The auditor should carry out necessary audit procedures to verify the information provided by the management.

The information may be reported in the Statement of Disputed Dues as nature of the dues, amounts, period which the amount relates and forum where dispute is pending.

(b) External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial statements.

As per SA 505, "External Confirmation", the auditor is required to maintain control over this process of selecting those to whom a request will be sent, the preparation and sending of confirmation requests and responses to those requests. This is because there have been several cases of clients presenting forged confirmation to auditors when such control was absent.

One of the debtors of more than 5 year old had confirmed his balance. The auditor should enquire into the debtor whose dues are outstanding for 5 years or more about his financial abilities and why he has not paid-reasons behind the same, and if found adverse, the client should be advised to provide for 'Provisions for Bad Debts' and also to confirm that it is not a 'Forged Confirmation'.

In the instant case the manager did not perform his duties adequately.

(c) As per AS-9 'Revenue Recognition', revenue involving sale of goods is to be recognised on transfer of significant risks and rewards of ownership to the buyer.

In the instant case, A Ltd has invoiced the goods and they have left the factory on 30th March, 2010. However the same is for export and the bill of lading is dated 3rd April 2010. Since the terms of export are "FOB" basis, the title in the goods passes to the buyer when the bill of lading is made. Accordingly the risk and rewards of ownership pass to the buyer on 3rd April, 2010.

The sale should be therefore, recognised in April, 2010 and not in March, 2010. The auditor will therefore have to qualify his report stating that revenues are overstated to that extent.

(d) Exemption for applicability of AS – 3, preparing Cash Flow Statement is available only to SMC (Small and Medium Size Companies) preparation of Cash Flow Statement, as per AS-3 is now made mandatory in respect of the following enterprises :-

(i) Enterprises whose equity of debt securities are listed on a recognised Stock Exchange in India and Enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised Stock Exchange in India.

(ii) All other Commercial, industrial and business reporting enterprises, whose turn over for the accounting period exceeds Rs. 50 crores.

In the instant case, LMN Pvt Ltd. did not prepare the Cash Flow Statement, even its turn over exceeded Rs. 50 crores. It is not considered as a small and medium size company as per Companies (AS) Rules, 2006 (AS-3) as discussed earlier, hereinabove.

Therefore, if LMN Pvt Ltd does not prepare cash flow statement it is a violation of AS 3 and section 211(3C) of the Companies Act, 1956.

The auditor will have to accordingly qualify his report that 211(3C) is not complied with, though the profit & loss account would give a 'True & Fair View'.

Question 2

Comment on the following with reference to the Chartered Accountants Act, 1949 as amended by the Chartered Accountants Act, 2006 and schedules thereto:

(a) M/s PQR, a firm of Chartered Accountants, responded to a tender from a State Government department for switching over to double entry system of accounting. For the purpose the firm also paid Rs. 20,000 as earnest money deposit as per the terms of the tender. *(4 marks)*

(b) K a Chartered Accountant in practice takes up appointment as Managing Director of XY Ltd. *(4 marks)*

(c) X was appointed statutory auditor in ABC Ltd. for the year ended 31st March, 2010. On inquiry, X found that his wife had acquired before a few years, 100 shares in the said company. She was still holding the shares with the name of X as joint holder. Can X accept the appointment? *(4 marks)*

(d) A is a partner of 3 firms, M/s ABC & Company and M/s A & Associates. For most of the audits handled by him, the appointment is in the name of M/s ABC & Company. The visiting cards of A carries the names of both the firms. *(4 marks)*

Answer

(a) In audit field which is exclusive for Chartered Accountants, when the services are to be provided to Govt. agencies, they seek tenders / quotations to ensure transparency and financial disciplines in their organisation. Considering this, the Council is of the opinion that the restriction in such case may be relaxed.

As per provision to Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949, a member can respond to tenders or enquiries issued by various users of professional services or organisations from time to time and secure professional work as a consequence.

In view of the above, M/s PQR, a firm of Chartered Accountants can respond to the tender and can also pay the earnest money deposit as per the terms of tender which will not constitute professional misconduct.

(b) As per Clause 11 of Part I of First Schedule to the Chartered Accountants Act, 1949, and the provisions contained in Regulation 190 A, a member in practice cannot engage himself in any business or occupation other than that of a Chartered Accountant except when permitted by the Council to be so engaged.

As per the Chartered Accountants Regulations, 1988, a Chartered Accountant in practice may hold the office of a Managing Director or whole time Director of a body corporate provided that the member/and or his relatives do not hold substantial interest in such concern after obtaining the specific and prior approval of the Council.

In the absence of specific and prior approval, the Chartered Accountant would be held liable and guilty of professional misconduct.

Thus if Mr. K has taken specific and prior approval, he will not be held guilty of professional misconduct. In the absence of such approval, Mr. K would be held liable and guilty of professional misconduct.

(c) As per Clause 9 of the Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant is deemed to be guilty of professional misconduct if he accepts an appointment of a company without first ascertaining from it whether the requirements of section 225 of the Companies Act, 1956 have been duly complied with. As per section 226(3) (e) of the Companies Act, 1956, a person is disqualified for appointment as an auditor if he holds any security (i.e. any instrument that carries voting rights) of that company.

In the instant case, since Mr. X is a joint holder of the 100 shares, he will be deemed to be a member and holding securities in the company. He would therefore, be disqualified for appointment as an auditor of ABC Ltd. Since X has accepted the audit inspite of his disqualification, he would be liable for misconduct.

(d) As per Clause 7 of the Part I of the First Schedule to the Chartered Accountants Act, 1949, a CA is deemed to be guilty of professional misconduct if he advertises his attainment or services. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public. Even a member is not permitted to specify the date of setting up of practice or establishment of firm. However, there is no prohibition for printing names of all the firms on the visiting cards in which a member holding Certificate of Practice is a partner.

In the instant case, A is a partner of 2 firms and his visiting cards carries the names of both firms. Though the appointment for most the audit work is in 1 firm's name, there is no bar in writing both names on his visiting cards. Thus there is no violation of the Code of Conduct on the part of Mr. A.

Question 3

Answer the following:

(a) What are the procedures to be followed by a statutory auditor for verifying the provision for accrued liability for retirement benefits which is based on a certificate of an reputed actuary?

(8 marks)

(b) Describe the areas where the Statutory Auditor of a company has to make: (8 marks)

(i) Statement of facts

(ii) Give his opinion.

Answer

(a) The procedures to be followed by a statutory auditor for verifying the provision for accrued liability for retirement benefits: Though an auditor is responsible for forming and expressing his opinion on financial information, the auditor is entitled to rely on the work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. The auditor should obtain reasonable assurance that work performed by the expert is adequate for his purpose.

The auditor while verifying the accrued liability for retirement benefits has to use the work of an expert i.e. an actuary. The manner of such reliance is laid down in SA 620 "Using the Work of an Expert". The general clarification issued by ICAI on the same provides that, in such a case, the issue to be considered is, whether it is sufficient for the auditor to rely on the certificate given by actuary without establishing the reasonableness of the assumptions made by the actuary based on the auditor's knowledge of the client's business.

The auditor should while using the actuary's certificate, obtain an understanding on the methods used by the actuary in determining the liability and judge the appropriateness and reasonableness of the assumptions with regards to the rate of return, number of employees, retirement age, salaries, promotion policy and age of employees etc., if appropriate, their consistency with the prior period.

The auditor should also seek reasonable assurance that the actuary has used the sufficient, relevant and reliable source data.

The auditor should also satisfy himself that the substance of the actuary's findings is properly reflected in the financial information.

(b) (i) The areas where the Statutory Auditor of a company has to make statement of facts: The statement of facts to be reported by the company auditor under section 227 of the Companies Act, 1956 are:

a) Whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit,

b) Whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him as required by section 228 (3) (c) and how he has dealt with the same in preparing the auditor's report.

c) Whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.

d) Whether any director is disqualified from being appointed as a director under section 274(1) (g) and

e) Whether the cess payable under section 441 A has been paid and if not, the details of the amount of cess not so paid.

(ii) The areas where the Statutory Auditor of a company has to give his opinion: The opinions which the auditor is required to express are:

a) Whether, proper books of account as required by law have been kept by the company so far as appears from the examination of the books and proper returns adequate for the purposes of the audit have been received from branches not visited by him.

b) Whether the profit and loss account and balance sheet, comply with the accounting standards referred to under section 211(3C).

c) Whether the accounts give the information required by the Act in the manner as required and

d) Whether the accounts give a true and fair view in case of balance sheet of the state of the company's affairs as at the end of its financial year and in the case of profit and loss account of the profits or loss for the year.

Question 4

Answer the following:

(a) What are the additional matters which the Statutory Auditor of a banking company has to state in his report? (4 marks)

(b) Describe briefly the major verification areas in a due diligence for a proposed merger. (6 marks)

(c) As an auditor, what are the indicators you would consider while verifying compliance with Laws and Regulations? (6 marks)

Answer

(a) The additional matters which the Statutory Auditor of a banking company has to state in his report: An auditor of a bank should express his opinion on the financial statements of a bank as per the Companies Act, 1956. In addition, an auditor is also required to report as per Banking Regulation Act, 1949 and other relevant Regulations and Guidelines of the Reserve Bank of India issued from time to time. The auditor has to report:

i. Whether or not the information and explanations required by him have been found during the course of audit were satisfactory or not;

ii. Whether or not the transactions of the company which have come to his notice have been within the powers of the company;

iii. Whether or not the returns received from the branch offices of the company have been found adequate for the purpose of his audit;

iv. Whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and

v. any other matter which he considers should be brought to the notice of the shareholders/users of the company.

(b) Major verification areas in a due diligence for a proposed merger: The purpose of due diligence is to assist the purchaser or the investor in finding out about the business he is acquiring or investing in, prior to completion of the transaction, including its critical success factors as well as its strength and weakness. The major verification areas in a due diligence for a proposed merger can be:

i. Brief description of the history of business

ii. The background of promoters

iii. Accounting policies & practices

iv. Management Information System

v. Details of Management structure

vi. Trading results both past and the recent past

vii. Assets & Liabilities as per latest balance sheet

viii. Current status of income tax assessments including appeals pending against tax liabilities, assessed by the tax authorities,

ix. Cash flow patterns

x. The projections of future profitability

(c) Indications for verifying compliance of Laws & Regulations (SA 250)

As per SA 250 (revised) "Consideration of Laws and Regulations in An Audit of Financial Statements" the indications of non-compliance with laws and regulations when the auditor becomes aware of the existence of, or information about, the following matters, it may be an indication of non-compliance with laws and regulations:

i. Investigation by regulatory organisations Government departments or payment of fines, additional taxes or penalties.

ii. Payments for unspecified services or loans to consultants related parties, employees or government employees.

iii. Sales commission or agents fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.

iv. Purchases at prices significantly above or below market price.

v. Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.

vi. Unusual payments towards legal and retainership fees.

vii. Unusual transactions with companies registered in tax havens.

viii. Payments for goods or services made other than to the country from which the goods or services originated.

ix. Payments without proper exchange control documentation.

x. Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.

xi. Unauthorised transactions or improperly recorded transactions.

xii. Adverse media comment.

Question 5

Answer the following:

(a) As an Internal Auditor of a Cement Manufacturing Company, draft an audit program for verification of transportation charges for dispatches from the factory. (8 marks)

(b) Discuss the reporting requirements in Form 3CD of the Tax Audit Report u/s 44AB of the Income-tax Act, 1961 for Accounting Ratios. (4 marks)

(c) What are the broad matters to be considered while obtaining knowledge of business for a new audit engagement of a manufacturing concern? (4 marks)

Answer

(a) Procedure for Audit of Transportation Charges

As an internal auditor or a Cement Manufacturing Company, draft an audit programme for verification of transportation charges for dispatches from the factory.

i. Check rates contracted with transporters for carriage of goods.

ii. Check whether the rates mentioned as per the contract are correctly taken in the transporter's invoice.

iii. In case of discrepancy, check whether the same is authorised by the appropriate sanctioning authority.

iv. Check that the transporter's invoice includes a delivery challan which has customers stamp indicating the receipt of goods.

v. In case there is no stamp on the delivery challan, check whether the goods are received back and there is a corresponding inward note.

vi. Check whether all the goods to be dispatched have a transport booking order reference.

vii. Check whether each transporter's invoice mentions the transport booking order reference.

viii. Check whether all the transport booking orders have corresponding transporters names.

ix. Check whether the transport booking orders are pre-numbered.

x. Check whether all the invoices are correctly booked in the books of accounts.

xi. In case there is an additional charge by the transporter due to extra carriage, check for the relevant supporting records (like material inward note/customer rejection note) and necessary authorisation by the sanctioning authority.

xii. Check whether service-tax on the transports is correctly calculated and accounted.

xiii. Verify that for there is a mechanism for linking all the transport bills to the sale invoices.

(b) Reporting requirements for Accounting Ratios in Form 3CD of Tax Audit:

Following Accounting Ratios have been prescribed:

- Gross Profit / Turnover
- Net Profit / Turnover
- Stock in Trade / Turnover
- Materials consumed / Finished goods produced

These ratios have to be calculated, only for assessees who are engaged in manufacturing or trading activities. This clause is not applicable to assessees carrying on profession. Moreover, the rates have to be given for the business as a whole and need not be given product wise.

(c) Knowledge of business for a new audit engagement of a manufacturing concern: The broad matters to be considered while obtaining knowledge of business for a new audit assignment are set out in SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment. These are:

(i) Relevant industry, regulatory, economic and other external factors including the applicable financial reporting framework

(ii) The nature of the entity, including:

(a) its operations;

(b) its ownership and governance structures;

(c) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

(d) the way that the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(iii) The entity's selection and application of accounting policies.

(iv) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

(v) The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgement regarding the appropriateness of accounting policies and disclosures.

Question 6

Write short notes on the following:

(a) Energy Audit

(b) Use of 'Check Lists' in Audit

(c) CEO/CFO Certification to the Board

(d) Audit Report under VAT *(4 x 4 = 16 marks)*

Answer

(a) Energy Audit: Energy audit is defined as an activity that serves the purpose of assessing energy use pattern of a factory or energy consuming equipment and identifying energy saving opportunities. It is the first step of any energy management programmes. In that context, energy management involves the approaches reducing avoidable losses, improving the effectiveness of the energy use, and increasing the energy use efficiency.

While performing the Energy Audit, the energy auditor is required to carry out the following activities:

(i) To analyse the historical energy consumption and cost data.

(ii) To conduct preliminary energy audit with the objectives to identify:

(a) major energy consuming equipment and process;

(b) obvious inefficiencies and energy wastes; and

(c) priority areas for further detailed investigation.

(iii) To conduct detailed technical and economic analysis of energy efficiency measures involving large efficiency measures involving large capital investment or long payback periods.

(iv) Conduct preliminary and detailed energy audits which should include the following:

(a) Data collection and analysis

(b) Measurements, mass and energy balances.

(c) Reviewing energy procurement practices.

(d) Identification of energy efficiency projects and techno-economic evaluation.

(e) Establishing action plan including energy saving targets, staffing requirements, implementation time requirements, procurement issues, details and cost estimates.

(f) Recommendation on goal setting for energy saving, record keeping, reporting and energy accounting, organisation requirements, communications and public relations.

(b) Use of 'Check Lists' in Audit: It is a series of instructions or questions on internal control which the auditor must follow or answer. When a particular instruction is carried out, the auditor initials the space opposite the instruction. If it is in the form of questions, the answers to the check list are usually 'Yes' "No" or "Not Applicable", is entered opposite the question. A Check list is more in the nature of a reminder to the auditor about the matters to be checked for testing the internal control system. Check list may be in a form of instructions, questions or just points to be checked, may be meant for the auditor's own staff.

The auditor should study the complete checklist to ascertain existence of Internal Control and evaluate its implementation and efficiency.

(c) CEO/CFO Certification to the Board: In terms of Corporate governance norms the CEO/CFO has to certify to the Board that:

- They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief:-
  - i. these statements do not contains any materially untrue statement or omit any material fact or contains statements that might be misleading;
  - ii. these statements together present a true & fair view of the company's affairs and are in compliance with existing accounting standard, applicable laws and regulations.
- -There are, to the best of their knowledge & belief no transactions entered into by the company during the year that are fraudulent, illegal or violative of the company's code of conduct.
- They accept responsibility for establishing and ~~&~~ maintaining internal controls for financial reporting and that, they have disclosed to the auditors and the Audit Committee.
- They have indicated to the auditors and the Audit Committee:
  - i. Significant changes in internal control during the year
  - ii. Significant changes in accounting policies during the year and the same have been disclosed in the notes to the financial statements and
  - Iii Instance of significant fraud of which they become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system.

(d) Audit Report under VAT: Several State VAT Legislations have provided for audit of accounts by Chartered Accountants. Such audit becomes necessary whenever the turnover of the assessee exceeds the prescribed limit under the relevant State VAT Legislations. Format of Audit report under VAT is prescribed under relevant VAT law.

The auditor has to fill in all the columns of the audit report that are applicable. The auditor is expected to give his opinions on the adequacy of accounting records, correctness and completeness and arithmetical consistency of returns filed. He is also expected to give the summary of additional tax liability/refund arising on his verification of the returns and books of account. The objective of furnishing such details is to help the VAT authorities to determine the correct turnover and also to satisfy themselves whether the VAT has been remitted properly to the credit of the State Government. Wherever applicable such particulars have to be verified by the Chartered Accountants. Such verification ensures that the input VAT credit has been claimed by the assessee in a proper manner.