

**PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS**

Question No. **1** is compulsory

Answer any **five** from the rest

**Question 1**

Comment on the following:

- (a) The auditor of SS Ltd. accepted the gratuity liability valuation based on the certificate issued by a qualified actuary. However, the auditor noticed that the retirement age adopted is 65 years as against the existing retirement age of 60 years. The company is considering a proposal to increase the retirement age. (5 Marks)
- (b) MRE Ltd. provided ₹ 25 lakhs for Inventory obsolescence in 2009-10. In the subsequent years, it was determined that 50% of such stock was usable. The Board of Directors wants to adjust the same through prior period adjustment. (5 Marks)
- (c) SRS Ltd. has drawn the financial statement as on 31-3-11 and presented to you alongwith additional information:

*Balance Sheet of SRS Ltd. as on 31-3-11*

| Liabilities                        | Amt.        | ,Assets            | Amt.        |
|------------------------------------|-------------|--------------------|-------------|
| Share capital                      | 50,00,000   | Fixed Assets       |             |
| Reserves & Surplus                 |             | Gross block        |             |
| Profit and Loss Alc                | 4,00,000    | Less: Depreciation | 1,00,00,000 |
| Secured Loans                      | 75,00,000   | Investments        | Nil         |
| Current Liabilities and Provisions |             | Current Assets     |             |
| Creditors for trade                | 3,00,000    | Loans & Advances   |             |
| Advance received                   | 3,00,000    | Debtors            | 25,00,000   |
|                                    |             | Advance Paid       | 10,00,000   |
|                                    | 1,35,00,000 |                    | 1,35,00,000 |

*Additional Information:*

- (a) Entire pre-operative expenses of ₹ 7,00,000/- was charged to Profit and .Loss Account whereas for the purpose of Income Tax, only what is allowable is claimed.
- (b) Depreciation as per Books - ₹ 35,00,000/-  
Depreciation as per Income tax - ₹ 50,00,000/-
- (c) Losses to be carried forward as per Income Tax Act - ₹ 16,00,000/-
- (d) Donation disallowed while computing tax - ₹ 50,000/-

*Considering the additional information, can you certify that the company has complied with the Accounting Standards and issue an unqualified report? (6 Marks)*

- (d) *ABC & Co. and DEF & Co, Chartered Accountant firms were appointed as joint auditors of Good Health Care Ltd. for 2009-10. A special audit was conducted U/s 233A of the Companies Act 1956 during March 2011 and observed gross understatement of Revenue. The revenue aspects were looked after by DEF & Co, but there was no documentation for the division of work between the joint auditors. (4 Marks)*

**Answer**

- (a) **Using the work of an Expert:** As per SA 620 "Using the Work of an Auditor's Expert", the expertise of an expert may be required in the actuarial calculation of liabilities associated with insurance contracts or employee benefit plans, however, the auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert.

Hence, the auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence as per SA 500.

If the expert's work involves use of significant assumptions and methods, then the relevance and reasonableness of those assumptions and methods and if the expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data in the circumstances must be ensured by the auditor.

In the instant case, a qualified actuary has issued a certificate for gratuity liability valuation, for which retirement age adopted is 65 years against the existing retirement age of 60 years; however, the company is considering a proposal to increase the retirement age. In view of SA 500 alongwith SA 620, the assumption made by actuary has no relevance and reasonableness as presently retiring age is of 60 years. Hence the auditor is required to bring out the facts to the notice of management and advice the modification accordingly. In case of failure of compliance of the same the auditor may qualify the report.

- (b) **Prior Period Adjustment:** As per AS 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The write-back of provision made in respect of inventories in the earlier year does not constitute prior period adjustment since it neither constitutes error nor omission but it merely involves making estimates based on prevailing circumstances when financial statements were being prepared. It is a mere estimate process involving judgement based on the latest information available.

An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or

subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

Further, as per SA 540 “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”, the auditor shall review the outcome of accounting estimates included in the prior period financial statements or where applicable, their subsequent re-estimation for the purpose of the current period.

In this case, MRE Ltd. provided ₹ 25 lakhs for inventory obsolescence in 2009 - 10. In the subsequent year due to change in circumstances, it was determined that 50% of such stock was usable. Revision of such an estimate does not bring the resulting amount of ₹ 12.5 lakhs within the definition either of a prior period item or of an extraordinary item. The amount, however, involved is material and requires separate disclosure to understand the financial position and performance of an enterprise. Accordingly, adjustment in the value of the inventory through prior period item would not be proper.

- (c) **Compliance with the Accounting Standards:** As per AS 26 “Intangible Assets”, when an expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised, then such an expenditure is recognised as an expense when it is incurred. Therefore, expenditures for commencing new operations or launching new products or processes (pre-operating costs) should be expensed off in the year of incurrence as no asset is created.

Further, as per AS 22 “Accounting for Taxes on Income”, tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period. It may also be noted that Deferred Tax is the tax effect of timing difference. Hence deferred tax should be recognised for all the timing differences, however, permanent differences do not result in deferred tax assets or deferred tax liabilities. Thus, Tax Expense = Current Tax + Deferred Tax.

Point no. (a) of additional information is in compliance with AS 26 hence no qualification is required in view of AS 26. But at the same time it leads to timing difference which will require the creation of DTA/ DTL as per AS 22. (DTA – Deferred Tax Assets, DTL – Deferred Tax Liabilities)

Similarly, point no. (b) and (c) of additional information are also the case of timing differences which creates DTA/ DTL as per AS 22.

Creation of DTA / DTL on account of such timing differences needs to be reported in the Financial Statements.

However, point no. (d) is a situation of permanent difference as per AS 22. Hence no DTA/DTL is required to be accounted for.

A prima facie look to the given balance sheet states that no tax expense has been provided for. Accordingly, qualification in audit report is required in view of non compliance of AS 22.

Further, presentations of Fixed Assets are also not in compliance with disclosure requirement of AS 6 and AS 10. Therefore, as an auditor, we cannot certify that the company has complied with all the Accounting Standards.

- (d) **Documentation for Division of Work between the Joint Auditors:** As per SA 299 "Responsibility of Joint Auditors", where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas.

In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would not be divided and would be covered by all the joint auditors.

The division of work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

Further, each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted audit procedures. It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner. Each joint auditor is entitled to rely upon the other joint auditors for bringing to his notice any departure from generally accepted accounting principles or any material error noticed in the course of the audit.

In the present case, there was no documentation for the division of work and the responsibility of revenue aspect was delegated to DEF & Co., in which gross understatement of revenue has been observed. ABC & Co. has not reviewed the work as they have put their reliance on the work performed by DEF & Co.

Hence, there is a violation of SA 299 as the division of work has not been documented. In the normal course DEF & Co. will be held liable for negligence. If DEF & Co. refuses to accept sole responsibility for the fault, ABC & Co. have to prove by other ways and means of evidences that the particular area of audit was exclusively done by DEF & Co. only.

## Question 2

*Comment on the following:*

- (a) *A Chartered Accountant in practice has been suspended from practice for a period of 6 months. During the said period, though he did not undertake the audit assignment since he had surrendered certificate of practice, he had appeared before Income Tax authorities in his capacity as a Chartered Accountant.* (4 Marks)

- (b) Mr. J, a Chartered Accountant has identified that ABC Ltd. has taken a loan of ₹ 15 lakhs from Provident Fund Account, during the course of audit. The said loan was not reflected in the books of accounts and statements were prepared ignoring the same. (4 Marks)
- (c) Mr. K, a Chartered Accountant certified the circulation of a weekly magazine without examining the records and relevant documents. (4 Marks)
- (d) Mr. R, a Chartered Accountant in practice approached Manager of a Nationalised Bank for a loan of ₹ 25 lakhs. He has also informed the Manager that if the loan is sanctioned, the Income Tax return of the Manager and staff will be filed without charging any fees, as quid Pro quo for the loan sanctioned. (4 Marks)

**Answer**

- (a) **Undertaking Tax Representation Work:** A chartered accountant not holding certificate of practice cannot take up any other work because it would amount to violation of the relevant provisions of the Chartered Accountants Act, 1949.

In case a member is suspended and is not holding Certificate of Practice, he cannot in any other capacity take up any practice separable from his capacity to practices as a member of the Institute. This is because once a member becomes a member of the Institute, he is bound by the provisions of the Chartered Accountants Act, 1949 and its Regulations.

If he appears before the income tax authorities, he is only doing so in his capacity as a chartered accountant and a member of the Institute. Having bound himself by the said Act and its Regulations made there under, he cannot then set the Regulations at naught by contending that even though he continues to be a member and has been punished by suspension, he would be entitled to practice in some other capacity.

Thus, in the instant case, a chartered accountant would not be allowed to represent before the income tax authorities for the period he remains suspended. Accordingly, in the present case he is guilty of professional misconduct.

- (b) **Failure to Disclose Material Facts:** As per Clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered Accountant in practice will be held liable for misconduct if he fails to disclose a material fact known to him, which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading.

In the present case, Mr. J has come across information that a loan of ₹ 15 lakhs has been taken by the company from Provident Fund. This is contravention of rules and the said loan has not been reflected in the books of accounts. Further, this material fact has also to be disclosed in the financial statements.

Mr. J has failed to disclose this fact in his report. Therefore, he is attracted by the provisions of professional misconduct under clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

- (c) **Failure to obtain information:** Clause 8 of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that if a Chartered Accountant in practice fails to obtain sufficient information to warrant the expression of an opinion or his exceptions are sufficient material to negate the expression of an opinion, the chartered accountant shall be deemed to be guilty of a professional misconduct.

Mr. K, a Chartered Accountant, certified the circulation of a weekly magazine without examination of records and other relevant documents. The chartered accountant should not express his opinion before obtaining the required data and information. As an auditor, Mr. K ought to have verified the basic records such as print order, printer's bill, number of copies sold and paid for, number of copies returned unsold to ensure the correctness of circulation figures.

Thus, in the present case, Mr. K will be held guilty of professional misconduct.

- (d) **Disrepute to the Profession:** Clause 2 of Part IV of First Schedule to the Chartered Accountants Act, 1949 states that member of the Institute, whether in practice or not, shall be deemed guilty of other misconduct, if he in the opinion of the Council, brings disrepute to the profession or to the Institute as a result of his action whether or not related to his professional work".

Accordingly, a Chartered Accountant is also expected to maintain the highest standards and integrity even in his personal affairs and any deviation from these standards calls for disciplinary action.

In the present case, the action of Mr. R, a Chartered Accountant in practice offering free service in return to sanction of loan brings disrepute to the profession of a Chartered Accountant.

Hence, Mr. R will be held guilty of other misconduct under Clause 2 of Part IV of the First Schedule of the Chartered Accountants Act, 1949.

### Question 3

- (a) XYZ Pvt. Ltd. has submitted the financial statements for the year ended 31-3-11 for audit. The audit assistant observes and brings to your notice that the company's records show following dues:

*Income Tax relating to Assessment Year 2007-08 ₹ 125 lacs - Appeal is pending before Hon'ble ITAT since 30-9-09.*

*Customs duty ₹ 85 lakhs - Demand notice received on 15-9-10 but no action has been taken to pay or appeal.*

*As an auditor, how would you bring this fact to the members? (5 Marks)*

- (b) *State the functions of Energy Auditor. (5 Marks)*

- (c) *A infrastructure company has constructed a mall and entered into agreement with tenants towards license fees (monthly rental) and variable license fees, a percentage on the turnover of the tenant (on an annual basis). Chief Finance Officer wants to*

*account/recognize license fee as income for 12 months during current year under audit and variable license fees as income during next year, since invoice is raised in the subsequent year. As an auditor, how would you deal and state in the statement of Accounting policies?* (6 Marks)

**Answer 3****(a) Reporting under Paragraph 4 (ix) of CARO, 2003**

- (I) 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. However, 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.

In the present case, there is Income Tax demand of ₹ 125 Lacs and the company has gone for an appeal, it needs considerations as to whether the entire demand is disputed, because it is difficult to presume that the demand by Income Tax authority is without any basis. Therefore, As per AS 29 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. Further, it should be brought to notice of members by reporting under Paragraph 4(ix) (b) of CARO, 2003 as per the requirement mentioned therein;

- (II) As per Paragraph 4 (ix) (a), the auditor has to report upon the regularity of the company in depositing undisputed statutory dues including provident fund, investor education and protection fund, employees' state insurance, income-tax, sales-tax, wealth-tax, service tax, custom duty, excise duty, cess and any other statutory dues to appropriate authorities. If the company is not regular in depositing the above mentioned undisputed statutory dues, the auditor is required to state the extent of arrears of statutory dues which have remained outstanding as at the last day of the financial year concerned for a period of more than six months from the date they became payable.

With reference to the regularity, in case of custom duty on import of goods or demands arising on account of assessment orders etc., which a company is required to pay as and when an event giving rise to the liability of the company occurs. Such dues should be construed to have been paid regularly if the company

deposits them as and when they become due. However, the auditor would be required to comment upon the regularity of the company in depositing the installments, if any, granted by an authority in respect of a demand against the company.

In the instant case, the demand notice has been received for Custom Duty of ₹ 85 Lacs on 15.09.2010 and is outstanding for more than 6 months, for which no action has been taken by the management, leads to the irregularity which should be brought to notice of members by reporting under Paragraph 4(ix)(a) of CARO, 2003.

**(b) Functions of Energy Auditor:** Energy auditing is defined as an activity that serves the purposes of assessing energy use pattern of a factory or energy consuming equipment and identifying energy saving opportunities. In that context, energy management involves the basis approaches reducing avoidable losses, improving the effectiveness of energy use, and increasing energy use efficiency. The function of an energy auditor could be compared with that of a financial auditor. The energy auditor is normally expected to give recommendations on efficiency improvements leading to monetary benefits and also advise on energy management issues. Generally, energy auditor for the industry is an external party. The following are some of the key functions of the energy auditor:

- (i) Quantify energy costs and quantities
- (ii) Correlate trends of production or activity to energy costs
- (iii) Devise energy database formats to ensure they depict the correct picture – by product, department, consumer, etc.
- (iv) Advise and check the compliance of the organisation for policy and regulation aspects.
- (v) Highlight areas that need attention for detailed investigations.
- (vi) 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) Recommendations on goal setting for energy saving, record keeping, reporting and energy accounting, organisation requirements, communications and public relations.

- (c) **Revenue Recognition:** AS 9 on Revenue Recognition, is mainly concerned with the timing of recognition of revenue in the statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction. However, when uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

Further, as per accrual concept of fundamental accounting assumptions given in AS 1 "Disclosure of Accounting Policies", revenue should be recognised as and when it is accrued i.e. recorded in the financial statements of the periods to which they relate.

In the present case, monthly rental towards licence fees and variable licence fees as a percentage on the turnover of the tenant though on annual basis is the income related to common financial year. Therefore, recognising the fees as revenue cannot be deferred simply because the invoice is raised in subsequent period. Hence it should be recognised in the financial year of accrual.

Therefore, the contention of the Chief Financial Officer is not in accordance with AS 9 and hence the auditor may qualify the report indicating the understatement of income/profit and that the profit and loss account does not exhibit a true and fair view of the profit or loss.

#### Question 4

- (a) *XY Ltd. is a manufacturing company, provided following details of wastages of raw materials in percentage, for various months. You have been asked to enquire into causes of abnormal wastage of raw materials.*

*Draw out an audit plan.*

*Wastage percentage are*

|                  |             |                  |
|------------------|-------------|------------------|
| <i>July 2010</i> | <i>1.5%</i> |                  |
| <i>Aug 2010</i>  | <i>1.7%</i> |                  |
| <i>Sep 2010</i>  | <i>1.4%</i> |                  |
| <i>Oct 2010</i>  | <i>4.1%</i> | <i>(8 Marks)</i> |

- (b) *Briefly explain the steps involved in Audit under Indirect Tax.* *(8 Marks)*

#### Answer

- (a) **Audit Plan to locate the Abnormal Wastage of Raw Material:** To locate the reasons for the abnormal wastage, the 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, pilferage 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.

In addition, some specific reasons for abnormal wastage in process may be considered by the auditor are as under:

- (1) 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.
- (2) Machine breakdown, power failure, etc. may also result into loss of materials in process. Check the machine utilisation statements.
- (3) 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.
- (4) It is possible that the wastage may have occurred because the particular lot out of which issues were made 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.
- (5) 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.
- (6) 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.
- (b) Steps involved in Audit under Indirect Taxes:** The components of central indirect tax which form a part of the cost could be basic customs duty, additional duty of customs, special additional duty, excise duty special excise duty, additional duties of excise, service tax etc. The various components have a relationship with each other and also with central and local sales tax. The audits in this area are governed under sections 14A and 14AA of the Central Excise Act, 1944. All these audits are conducted by or on behalf of the Government. The steps involved in conducting indirect tax audit are as under:
1. Evaluate the internal control systems in general with specific weight given to the strength of the systems in aiming at the quantification and discharge of the indirect taxes. The auditor should ensure that the accounting system and related internal control in this area are covered appropriately. Internal control questionnaire may be designed specifically for the area of indirect taxation.
  2. Obtains information about the company and the industry. Specific information on amount of imports, percentage of customs, amount of removals, and quantum of Cenvat-proportion of credit could also be calculated. The walk through of the process from the point of ordering of materials till the receipt of the payment from the customer is advisable.
  3. Formulating an audit programme to assist in the actual conduct of the audit. The actual extent of verification would be dependent on the results of the evaluation of the internal controls.
  4. Ensure that the audit staff is knowledgeable in the law and the procedures governing the indirect taxes. The examination of the documents, physical verification, reconciliation tracing techniques, comparison of ratios, observation of the activities and discussions of the weaknesses observed should be part of an effective audit.
  5. Prepare a report on the indirect tax audit providing specific comments on the statutory information, material matters reported by way of an executive summary and the assertion/qualification that the acceptable accounting policies are in vogue.

### Question 5

- (a) As a tax auditor how would you deal and report the following:
- (i) An assessee has borrowed ₹ 50 lakhs from various persons. Some of them by way of cash and some of them by way of Account payee cheque /Draft.

- (ii) An assessee has paid Rent to his brother ₹ 2,50,000/- and paid interest to his sister ₹ 4,00,000/-
- (iii) An assessee has incurred payment to clubs. (3 + 2 + 2 = 7 Marks)
- (b) As a bank branch auditor, what aspects will be considered while reporting on credit appraisal, sanctioning /disbursement and documentation in respect of advances in the LFAR? (5 Marks)
- (c) ABC Private Ltd. has granted loan of ₹ 20 crores to XYZ Ltd. a sister concern and it remains outstanding at the year end. How would you report the fact? (4 Marks)

### Answer

#### (a) Tax Audit Report

- (i) **Borrowal of ₹ 50 Lakhs :** As per Clause 24 of Form 3CD the particulars of each loan or deposit taken or accepted during the previous year have to be stated in the Tax Audit Report.

Further, Clause 24 (a) requires reporting in case if the loan or deposit was taken or accepted otherwise than by an account payee cheque or an account payee bank draft". In addition, as per Clause 24(c) the tax auditor has to state whether a certificate has been obtained from the assessee regarding taking or accepting loan or deposit, through an account payee cheque or an account payee bank draft. The mere obtaining of such certificate does not reduce the responsibility of the tax auditor to verify the compliance with the provisions of section 269SS and 269T of the Income Tax Act.

Therefore, in the present case, where the assessee has borrowed ₹ 50 Lakhs by way of cash and some of them by way of Account payee cheque/ draft, needs to be verified and to be reported in compliance with Clause 24 of Form 3CD.

- (ii) **Payment of Rent and Interest:** A tax auditor has to report under Clause 18 of Form 3CD which deals with the particulars of payments made to persons specified under Section 40A (2) (b). The specified persons include Husband, Wife, Brother, Sister or any other Lineal Ascendant or Descendant.

In the present case, an assessee has paid rent to his brother ₹ 2, 50,000 and interest to his sister of ₹ 4,00,000 may be disallowed if, in the opinion of the Assessing Officer, such expenditure is excessive or unreasonable having regard to:

- (1) the fair market value of the goods, services or facilities for which the payment is made; or
- (2) for the legitimate needs of business or profession of the assessee; or
- (3) the benefit derived by or accruing to the assessee from such expenditure.

Hence this fact needs to be reported in the Tax Audit Report accordingly.

- (iii) **Payment to Club :** As per Clause 17(d) of Form 3CD the amount of payments made to clubs by the assessee during the year should be indicated.

The payments may be for entrance fees as well as membership subscription and for catering and other services by the club, both in respect of directors and other employees in case of companies and for partners or proprietors in other cases. The fact whether such expenses are incurred in the course of business or whether they are of personal nature should be ascertained. If they are personal in nature, they are to be shown separately under Clause 17(b).

Hence, the tax auditor has to report the payments to clubs under Clause 17 (d) of Form 3CD.

- (b) **Verification of advances in the Long Form Audit Report (LFAR):** The auditor has to comment on various specific issues as mentioned in the Long Form Audit Report of the bank. While evaluating the efficacy of internal controls over advances, the auditor should particularly examine those aspects on which he is required to comment in his long form audit report.

Thus, he should examine:

- (i) Whether the loan applications are complete and in prescribed form;
- (ii) Procedural instructions regarding grant/ renewal/ enhancement of facilities have been complied with;
- (iii) Sanctions are within delegated authority and disbursements are as per terms of the sanction;
- (iv) Documentation is complete; and supervision is timely, effective and as per prescribed guidelines.

The auditor can gather the requisite evidence by examining relevant documents (such as loan application forms, supporting documentation, sanctions, security documents, etc.) and by obtaining information and explanations from the branch management in appropriate cases.

The auditors must familiarise themselves with those issues and guidance relating to the same and should cover the same during the regular course of audit of advances.

- (c) **Reporting of loan under CARO, 2003:** As per Paragraph 4(iii) (a) of CARO, 2003 the auditor has to report whether the company has granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 301 of the Companies Act, 1956. If so, give the number of parties and amount involved in the transactions; and further as per Paragraph 4(v)(a) "Whether the particulars of contracts or arrangements referred to in section 301 of the Companies Act, 1956, have been entered in the register required to be maintained under that section"

Hence, in the instant case ABC Private Ltd. has granted loan of ₹ 20 crores to XYZ Ltd., a sister concern needs to be reported as per Paragraph 4 (iii) (a) and 4 (v) (a) of CARO, 2003.

**Question 6**

- (a) *Corporate responsibility as envisaged under Sarbanes and Oxley Act-2002. Briefly explain.* (3 Marks)
- (b) *State briefly the basic elements of Management Representation Letter.* (2 Marks)
- (c) *You are a member of an audit team of B & C Associates, auditors of a Multinational Company YB Co. Ltd. The company is working in CIS environment. The partner in charge of B & C Associates asked you to draw out the audit plan for evaluating the reliability of controls.* (5 Marks)
- (d) *Y Co. Ltd. has five entertainment centers to provide recreational facilities for public especially for children and youngsters at 5 different locations in the peripheral of 200 kilometers. Collections are made in cash. Specify the adequate system towards collection of money.* (6 Marks)

**Answer**

- (a) **Corporate Responsibility under Sarbanes Oxley Act of 2002 :** The Sarbanes–Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002 is a United States federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom. The act contains eleven titles and establishes corporate accountability and civil and criminal penalties for white – collar crimes. The title three deals with the Corporate Responsibility which is as follows:
  - (1) The audit committee to be more independent through enhancement of their oversight responsibilities and one of the Audit committee members to be financial expert.
  - (2) Requires CEO& CFO to issue certification of the quarterly financial results and annual reports to SEC as part of compliance with Form 10K
  - (3) Provides rules of conduct for companies managerial and their officers regarding Pension matters.
  - (4) To Comply with SEC rules requiring attorneys to report violation of securities to the company's CEO or Chief Legal Counsel and to Audit Committee if no action is taken.
- (b) **Basic Elements of a Management Representation Letter:** As per SA 580 "Written Representation", some of the basic elements of a Management Representation letter are:
  - (1) It is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence.

- (2) It does not include financial statements, the assertions therein, or supporting books and records.
  - (3) The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement.
  - (4) The written representations shall be for all financial statements and period(s) referred to in the auditor's report.
- (c) **Audit Plan for Evaluating the Reliability of Controls in CIS Environment:** In evaluating the effects of a control, the auditor needs to assess the reliability by considering the various attributes of a control. Some of the attributes for example are that the control is in place and is functioning as desired, generality versus specificity of the control with respect to the various types of errors and irregularities that might occur, general control inhibit the effect of a wide variety of errors and irregularities as they are more robust to change controls in the application sub-system which tend to be specific control because component in these sub-system execute activities having less variety, that whether the control acts to prevent, detect or correct errors etc.

The auditor focuses here on

- (1) Preventive controls: Controls which stop errors or irregularities from occurring.
- (2) Detective controls: Controls which identify errors and irregularities after they occur.
- (3) Corrective controls: Controls which remove the effects of errors and irregularities after they have been identified.

The auditors are expected to see a higher density of preventive controls at the early stages of processing or conversely they expect to see more detective and corrective controls later in system processing.

Further, while evaluating the reliability of controls, the auditor should:

- (i) Ensure that authorized, correct and complete data is made available for processing;
- (ii) Provide for timely detection and correction of errors.
- (iii) Ensure that the case of interruption in the work of the CIS environment due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records;
- (iv) Ensure that accuracy and completeness of output;
- (v) Provide adequate data security against fire and other calamities, wrong processing, frauds etc.,
- (vi) Prevent unauthorized amendments to the program;
- (vii) Provide for safe custody of source code of application software and data files.

- (d) **Control System over Selling and Collection of Tickets:** In order to achieve proper internal control over the sale of tickets and its collection by the Y Co. Ltd., following system should be adopted
- (1) Printing of tickets: Serially numbered pre-printed tickets should be used and designed in such a way that any type of ticket used cannot be duplicated by others in order to avoid forgery. Serial numbers should not be repeated during a reasonable period, say a month or year depending on the turnover. The separate series of the serial should be used for such denomination.
  - (2) Ticket sales: The sale of tickets should take place from the Central ticket office at each of the 5 centres, preferably through machines. There should be proper control over the keys of the machines.
  - (3) Daily cash reconciliation: Cash collection at each office and machine should be reconciled with the number of tickets sold. Serial number of tickets for each entertainment activity/denomination will facilitate the reconciliation.
  - (4) Daily banking: Each day's collection should be deposited in the bank on next working day of the bank. Till that time, the cash should be in the custody of properly authorized person preferably in joint custody for which the daily cash in hand report should be signed by the authorized persons.
  - (5) Entrance ticket: Entrance tickets should be cancelled at the entrance gate when public enters the centre.
  - (6) Advance booking: If advance booking of facility is made available, the system should ensure that all advance booked tickets are paid for.
  - (7) Discounts and free pass: The discount policy of the Y Co. Ltd. should be such that the concessional rates, say, for group booking should be properly authorized and signed forms for such authorization should be preserved.
  - (8) Surprise checks: Internal audit system should carry out periodic surprise checks for cash counts, daily banking, reconciliation and stock of unsold tickets etc.

#### Question 7

Write short notes on any **four** of the following:

- (a) *Contract notes in case of audit of member of Stock Exchange.* (4 Marks)
- (b) *Scope of Peer Review.* (4 Marks)
- (c) *Audit procedure in respect of "Outstanding premium and Agents balance" in Insurance company.* (4 Marks)
- (d) *Comptroller & Auditor General of India were conducting supplementary audit U/s 619 (3) of the Companies Act, 1956 made certain comments on the reported foreign*

*exchange loss in the accounts of a Public sector company. The Board of Directors failed to reply to the comments of C & AG in their report- Comment.* (4 Marks)

(e) *Propriety elements in CARO 2003.* (4 Marks)

**Answer**

(a) **Contract Notes in case of Audit of Member of Stock Exchange:** Contract note is a document through which a contractual obligation is established between a member and a client. Every member of the stock-exchange has to issue contract notes to his clients for the trades executed on their behalf. The contract notes are required to be issued to the client within 24 hours of execution of the trades. Members are also required to preserve counter-foils or duplicates of the copies of contract notes issued to clients. The member is also required to maintain written consent of clients for the contracts entered into as Principal. Contract notes issued to clients should show the brokerage separately. The total brokerage charged by the member should not exceed the specified value of the trade. It may be noted that the brokerage percentage is prescribed from time to time. The Contract Notes are required to be signed either by the member himself or his constituted attorney. In case of a sole proprietor / partnership firm wishes to authorise another person to sign the contract notes, then the member is required to submit a power of attorney to the Exchange. In case of corporate membership, a board resolution is required to authorise a person including Directors to sign the contract notes.

The member then prepares a Contract Note in the prescribed form after adding the brokerage and sends the original Contract Note to the client. The auditor should evaluate the internal control procedures instituted by the stock broker for proper maintenance and issuance of contract notes. The auditor should verify that the transactions done by a member are recorded in the sauda book. It should also be examined that contract notes are issued for all the business conducted on behalf of the clients. The auditor should verify the list of trades executed with the bills raised.

(b) **Scope of Peer Review:** The Statement on Peer Review (ICAI, 2002) lays down the scope of review to be conducted. The peer review process is directed at the attestation services of a practice unit:

- (1) Once a practice unit is selected for review, its attestation engagement records pertaining to the immediately preceding three completed financial years shall be subjected to review.
- (2) The Review shall focus on:
  - (i) Compliance with Technical Standards
  - (ii) Compliance with Ethical Standards.
  - (iii) Compliance with Professional Standards.
  - (iv) Quality of Reporting.

- (v) Office systems and procedures with regard to compliance of attestation services systems and procedures.
- (vi) Training Programs for staff (including Articled and Audit Assistants) concerned with attestation functions, including appropriate infrastructure.

**(c) Audit procedure in respect of "Outstanding Premium and Agents Balance" in Insurance company:** The following are the audit procedures to be followed for verification of outstanding premium and agents' balances:

- .. Scrutinise and review control account debit balances and their nature should be enquired into.
- .. Examine inoperative balances and treatment given for old balances with reference to company rules.
- .. Enquire into the reasons for retaining the old balances.
- .. Verify old debit balances which may require provision or adjustment. Notes of explanation may be obtained from the management in this regard.
- .. Check age-wise, sector-wise analysis of outstanding premium.
- .. Verify whether outstanding premiums have since been collected.
- .. Check the availability of adequate bank guarantee or premium deposit for outstanding premium.

**(d) Reply of Board of Directors on the comments of C & AG :** Section 217(3) of the Companies Act, 1956 imposes a duty on the Board of Directors of a company to give the fullest information and explanations in the Directors' Report regarding every reservation, qualification or adverse remarks contained in the auditors' report. The Board's remarks on the auditors' report are to be given as an addendum to the report and are to form part of the main body of the report as per Section 217(3).

However there exists no mandatory requirement for the Board of Directors of a government company to give their reply on the reservations made by C&AG. Hence the Board of Directors of the Company is not bound to give information or explanation in respect of C&AG comments.

Therefore, the Board of Directors has not contravened any of the provisions of the Companies Act.

**(e) Propriety elements in CARO, 2003 :** The following are the Propriety elements in CARO, 2003

- (1) If the company has given or taken loans, secured or unsecured, to/from companies, firms or other parties listed in the register maintained under section 301 of the Companies Act, 1956, whether the rate of interest and other terms and conditions of such loans are *prima-facie* prejudicial to the interest of the company. In this case, the auditor will have to look into the reasonableness of the rate of interest and the terms and conditions of such loans. In other words, he will have to see whether the

terms and conditions, including the rate of interest are apparently adverse to the interests of the company, having regard to the circumstances of the company at the time of taking the loans and the terms normally available. He is to exercise his judgment based on commercial considerations like urgency, security offered etc.

- (2) If the overdue amount of the loan given to or taken from companies, firms or other parties listed in the register maintained under section 301 of the Companies Act, 1956, is more than rupees one lakh, what reasonable steps have been taken by the company for recovery/payment of the principal and interest. In making this examination, the auditor would have to consider the facts and circumstances of each case, including the amounts involved. It is not necessary that steps to be taken must necessarily be legal steps. Depending upon the circumstances, period of delay and other similar factors, issue of reminders or sending of advocate's or solicitor's notice may amount to reasonable steps. The auditor should ask the management to give in writing the steps which have been taken. The auditor should arrive at his opinion only after consideration of the management's representations.
- (3) Whether the transactions needed to be entered in a register in pursuance of section 301 of the Companies Act, 1956, have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time. Section 301 requires that every company shall keep one or more registers in which it shall be entered separately the particulars of all contracts or arrangements to which sections 297 and 299 of the Companies Act, 1956 apply. As regards the reasonability of prices, the auditor is not expected to make a roving market inquiry but to examine price lists, quotations, prices for other parties etc. He should also take into account the factors such as delivery period, quality, quantity involved, credit terms etc.
- (4) Is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employee State Insurance, Income-Tax, Sales Tax, Wealth Tax, Custom Duty, Excise Duty, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the day they became payable, shall be indicated by the auditor.
- (5) Whether the company has made any preferential allotment of shares to parties and companies covered in the register maintained under section 301 of the Companies Act, 1956 and if so whether the price at which shares have been issued is prejudicial to the interest of the company.