

THE COMPANY AUDIT

Question 1

State your views as an auditor on the following:

- (a) *T Ltd. purchased goods on credit for Rs.5 crores for export from ABC Ltd. Upon the export order being cancelled, T Ltd. decided to sell the same in the domestic market at a discounted price. Accordingly ABC Ltd was requested to offer a price discount of 25%. ABC Ltd. wants to adjust the sales figure to the extent of discount requested by T Ltd.*
- (b) *During the year under audit Z Ltd. credited to the Profit and Loss Account, the entire profit of Rs.20 lakhs on the sale of land not required for its use. You are informed that the directors would like to propose dividend out of the above profit.*
- (c) *Y Ltd. provided Rs.25 lakhs for inventory obsolescence in 1998-1999. In the subsequent years, it was determined that 50% of such stock was usable. The company wants to adjust the same through prior period adjustment account as the provision was made in the earlier year.*

Answer

- (a) ABC Ltd. had sold goods on credit worth Rs.5 crores to T Ltd. and, therefore, the sale was complete in all respects. T Ltd' s decision to sell the same in the domestic market at a discount does not affect the amount booked under sales by ABC Ltd. The price discount of 25% offered by ABC Ltd. at the request of T Ltd. was not in the nature of discount given during the ordinary course of trade because otherwise same would have been given at the time of sale itself. Now as far as ABC Ltd. is concerned, there appears to be an uncertainty relating to collectability, which has arisen subsequent to the time of sale. Therefore, it would be appropriate to make a separate provision to reflect the uncertainty relating to collectability rather than to adjust the amount of revenue originally recorded. Therefore such discount should be charged to the profit and loss account separately and not shown as deduction from the sales figure.
- (b) Profit of Rs. 20 lakhs on the sale of land is a capital profit. It represents the excess of sale value over the original cost of the asset.

As per Guidance Note on 'Audit of Payment of Dividend', capital profits can be distributed as dividend only if all the following conditions are fulfilled:

- (i) the Articles or the bye-laws or other rules and regulations applicable to the entity, permit such distribution; and

- (ii) it has been realised in cash; and
- (iii) the Board or similar authority is satisfied that net aggregate value of the assets remaining after distribution of that profit will not be less than the book values so that share capital and reserves remaining after the distribution will be fully represented by the remaining assets.

Accounting Standard 10 on "Accounting for Fixed Assets" also requires that any gain arising from disposal of a fixed asset should be recognised in the profit and loss account. Moreover, section 205 of the Companies Act, 1956 does not make any distinction between capital profit and other profit. Thus, all profits which can properly be taken to the profit and loss account are 'profits' for the purposes of section 205 and are, thus, distributable.

- (c) 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. In this case, Y Ltd. provided Rs.25 lakhs for inventory obsolescence in 1998-99. 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 RS.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.

Question 2

You have been appointed a statutory auditor of a limited company engaged in the manufacture of chemicals. What would be your views on the following?

- (a) *The management tells you that the work in process is not valued since it is difficult to ascertain the same in view of the multiple processes involved and in any case the value of opening and closing work in process would be more or less the same.*
- (b) *The company has a turnover exceeding Rs.5 crores for a period of three consecutive financial years immediately preceding the financial year concerned, but does not have any internal audit system.*

- (c) *The management tells you that there is no need for them to follow accounting standards specified by the Institute of Chartered Accountants of India as these are for the auditor to follow.*

Answer

- (a) **Valuation of Work-in-Process:** As per AS 2 (Revised) on "Valuation of Inventories", the inventories also include those assets which are in the process of production for sale in the ordinary course of business apart from finished goods and those materials or supplies to be consumed in the production process or in the rendering of services. It is, thus, necessary for a company to ensure that each and every component of inventory is valued properly. The argument advanced by the company that it is difficult to ascertain the same in view of the multiple processes involved is not acceptable. Because, the Guidance Note on "Audit of Inventories" also recognises the likely difficulties in valuation of work-in-process and states that, "in general, the audit procedures regarding work-in-process are similar to those used for raw materials and finished goods. However, the auditor has to carefully assess the stage of completion of the work-in-process for assessing the appropriateness of its valuation. For this purpose, the auditor may examine the production / costing records (for example, cost sheets), hold discussions with the personnel concerned and obtain expert opinion, where necessary".

The argument that the opening and closing work-in-process would be more or less the same is also not justified because the omission of those would lead to distortion in true and fair view. Further, costs incurred for raw materials and the overheads would normally be different and would give rise to different value of opening and closing stock. The Guidance Note even requires the auditor to ascertain the system from which the value of work-in-process is obtained is reliable, and to examine subsequent records of production / sales.

Therefore, in view of the above, the auditor shall have to qualify the audit report in case work-in-process is not valued and shown in the financial statements.

- (b) **Existence of Internal Audit System:** Para 4(vii) of the CARO, 2003 issued under section 227(4A) of the Companies Act, 1956, requires a statutory auditor to comment whether the auditee company has an internal audit system commensurate with its size and nature of its business. This is, however, applicable only if the company has a paid-up capital exceeding Rs.50 lakhs as at the commencement of the financial year concerned or has an average annual turnover exceeding Rs.5 crores for a period of three consecutive financial years immediately preceding the financial year concerned.

In the instant case, the second condition is met and thus the auditor is required to make an inquiry whether the company has an internal audit system commensurate with its size and nature of its business. Since the internal audit system is not in existence, the auditor will have to mention the fact of not having such a system in his CARO Report. The fact that the company does not have an internal audit system commensurate with its size and

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nature of its business would also have repercussions on the normal audit procedures since the efficacy of internal control system would itself be questionable. Under the circumstances, apart from disclosing the fact of non-existence of the internal audit system in the report, the auditor should also modify substantive audit procedures as well.

- (c) **Observance of Accounting Standards:** In terms of Companies Accounting Standards Rules 2006 prescribed by the Central Government under section 211 3(c) of the Companies Act, 1956. It is mandatory for a Company to follow all the prescribed Accounting Standards while preparing and presenting its financial statements. If a Company does not follow Accounting Standards the auditor is required to give a qualification in his report in terms of section 227(3) of the Companies Act, 1956. Infact directors of the companies are also required to give a written statement as part of Director Responsibility Statement under section 217 of the Companies Act that all the Accounting Standard prescribed has been followed and there are no discrepancies. In view of the provision the contention of the company is not correct.

Question 3

Comment on the following:

- (a) *The Accounting Standards issued by the Institute of Chartered Accountants of India need to be followed only by limited companies and not by partnership firms or proprietorships.*
- (b) *For Excise Duty on finished goods in stock as at the end of the year, there is an option available to provide for the same or to show the same as a Contingent liability.*

Answer

- (a) **Applicability of Accounting Standards:** The Preface to the Statements of Accounting Standards clarifies that the Accounting Standards are issued "for use in the presentation of general purpose financial statements issued to the public by such commercial, industrial or business enterprises, as may be specified by the Institute from time to time and subject to the attest function of its members. The term 'General Purpose Financial Statements' includes balance sheet, statement of profit and loss and other statements and explanatory notes which form part thereof, issued for use of shareholders/ members, creditors, employees and public at large". As far as companies, whether limited or unlimited incorporated under the Companies Act, 1956 are concerned, all such companies are expected to adhere to specified accounting standards in terms of section 211(3A) of the said Act. Even otherwise, such a requirement seems to be implicit even in the absence of specific statutory provisions since the application of accounting standards is an integral component so as to ensure that the financial statements give a true and fair view. Accordingly, the compliance with accounting standards has to be examined by the auditors while auditing general purpose financial statements which are statutorily required to be audited under any law. Thus, compliance with accounting standards is required to be examined by an auditor in an audit of financial statements of individuals and non-corporate enterprises (viz., sole proprietary concerns, partnership firms, societies registered under

the Societies Registration Act, trusts, Hindu Undivided Families, and associations of persons) only where the financial statements are statutorily required to be audited under any law. The accounting standards are also applicable to commercial, industrial or business activities of even charitable or religious organisations. Accounting Standards do not apply to those organisations whose entire activities are not of commercial, industrial or business nature, e.g., an organisation collecting donations to finance education of poor children. However, even if a very small proportion of the activities of an entity is commercial, industrial or business in nature, the accounting standards will apply to all its activities. Thus, the Council has made it clear that compliance with accounting standards required to be examined in an audit of financial statements of non-corporate enterprises only where the financial statements are required to be audited under any statutory enactment. For instance, in case there is no statutory requirement for such entities to prepare accounts on accrual basis, the auditor would not qualify but simply disclose the basis of accounting followed. Therefore, accounting standards as prescribed under Companies Accounting Standards Rule 2006 which are virtually in the same line as issued by the ICAI are to be followed not only by limited companies but also by partnership firms or proprietorships.

- (b) **Accounting Treatment of Excise Duty:** The AS 2 (Revised) on, "Valuation of Inventories" states that finished goods are to be valued by taking into account the costs of purchase, costs of conversion and other costs incurred in bringing the inventories to the present location and condition. The costs of conversion to be included would be all direct factory overheads related to the said finished goods. Excise duty is a duty which is payable on the manufacture of the finished goods inside a factory. Though the collection of the same is deferred till the goods leave the factory, the liability for the same arises when the manufacture takes place.

It is mandatory for an entity to provide for liability for excise duty on finished goods lying in stock at the end of the year and add the same to the value of closing stock. According to Guidance Note on "Accounting Treatment of Excise Duty", excise duty should be considered as a manufacturing expense and like other manufacturing expenses be considered as an element of cost for inventory valuation. Where excise duty is paid on excisable goods and such goods are subsequently utilised in the manufacturing process, the duty paid on such goods, if the same is not recoverable from taxing authorities, becomes a manufacturing cost and must be included in the valuation of work-in-progress or finished goods arising from the subsequent processing of such goods. Further, where the liability for excise duty has been incurred but its collection is deferred, provision for the unpaid liability should be made. Excise duty cannot be treated as a period cost. Accordingly excise duty now cannot be shown as a contingent liability. Thus, it is now mandatory for an entity to provide for liability for excise duty on finished goods lying in stock at the end of the year and add the same to the value of closing stock. If the said provision is not made, the revised Guidance Note on Accounting Treatment for Excise duty says that the auditor should qualify his report and, if possible, also mention the quantum of the duty not so provided.

Question 4

As a statutory auditor of a Public Limited Company, how would you deal with the following situations?

- (a) The company has sold some old machinery for Rs. one crore. The details of the cost of such machinery are not available since the entire records relating to fixed assets have been destroyed in an earthquake.*
- (b) The company had subscribed to shares of associate companies amounting to Rs.5 crores. These associate companies have incurred substantial losses and have been referred to BIFR for being declared as sick companies. The company does not want to make any provision for the fall in the value of the investments.*
- (c) As at the beginning of the year, the company has a capital of Rs.2.50 crores, free reserves of Rs.0.50 crore and Revaluation Reserve of Rs.4.50 crores. In the relevant year under audit the company has incurred a loss of Rs.4 crores. The company proposes to adjust the loss with the Revaluation Reserve.)*

Answer

- (a) Sale of Machinery:** AS 10 on "Accounting for Fixed Assets", gains or losses arising on disposal are generally recognised in the profit and loss statement. Therefore, when the company sells old machinery, profit/loss on sale thereof has to be determined. Such profit or loss can be determined provided the cost and written down value of the said machinery is available. In the instant case, since the entire records of fixed assets have been destroyed, the cost and the WDV of the machinery sold could not be arrived at. The company may therefore, have to determine the same on some estimated basis provided all reasonable efforts to determine the cost/WDVs of the machinery do not yield any better result. An all out attempt should be made by the management to reconstruct the old records. Such records may be constructed by obtaining old copies of annual reports distributed amongst shareholders, annual accounts filed with Registrar of Company, IT Returns filed by the auditor may also be having record of physical verification of earlier years etc. In fact, through this process, the company shall be able to determine the WDV of the asset because the machinery sold seems to be quite big and must have been recorded on stand alone basis.

The auditor will have to see whether the estimate of cost and wdv arrived at in the above manner by the company is reasonable and whether the profit/loss is determined accordingly. A note to that effect would also have to be given by the management in the accounts. If the auditor is of the opinion that the said estimates are satisfactory based on available records and the note given by management explains the said fact, he may not qualify his report. If he is not so satisfied, he would have to give disclaimer in the audit report that in the absence of proper records, the said profit/loss has been arrived on an estimated basis and in that view he has been unable to form an opinion. As far as the report under the CARO, 2003 order is concerned, the auditor would have to point out that proper records of fixed assets showing full particulars as required by that clause are not available.

- (b) **Valuation of Investments:** AS 13 on "Accounting for Investments" requires investments to be classified as long term and current investments distinctly in its financial statements. Since the investment in share of associate company is intended to be kept for a period more than one year, they would be classified as long term investment.

AS 13 states, "long-term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually". In the instant case, these associate companies have incurred substantial losses and have been referred to BIFR for being declared as sick companies. The net worth of these companies would have been wiped out resulting in a fall in the value of the investments. Therefore, such fall cannot be merely temporary as the companies could take a long time to turn around (if at all) and again have a positive net worth. The auditor would therefore have to qualify his report by saying that no provision for diminution for fall in the value of investments as required by AS 13 has been made and to that extent the profits and reserves have been overstated.

- (c) **Adjustment of Loss against Revaluation Reserve:** AS 10 on "Accounting for Fixed Assets" states that an increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. A decrease in net book value arising on revaluation of fixed assets is charged to profit and loss statement except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve, it is sometimes charged against that earlier increase. It sometimes happens that an increase to be recorded is a reversal of a previous decrease arising on revaluation which has been charged to profit and loss statement in which case the increase is credited to profit and loss statement to the extent that it offsets the previously recorded decrease. The Guidance Note on Treatment of Reserve created on Revaluation of Fixed Assets states that where the value of fixed assets is written up in the books of account of a company, the corresponding credit appearing as revaluation reserve does not represent a realised gain and is, therefore, not available for distribution as dividend. Similarly, accumulated losses and the depreciation on the acquisition cost (including arrears of depreciation) should not be adjusted against revaluation reserve since this would amount to setting off actual losses against unrealised gains.

The auditor should explain to the management that accumulated losses cannot be adjusted against the revaluation reserve created on revaluation of the fixed assets. In case the company in question does so, the balance sheet of the company will not reflect a true and fair view of the state of affairs of the company keeping in view the magnitude of the amounts involved, i.e., accumulated losses amount to Rs.4 crores and share capital and reserves amount to Rs.3 crores (excluding revaluation reserve). If the management does not agree with the opinion of the auditor, the auditor may even issue an adverse report.

Question 5

As an auditor state your views on the following situations:

- (a) *Included under Current Assets of XYZ Ltd. is inventory aggregating to Rs.20 crores. A part of the said inventory manufactured for export had to be sold earlier at a discounted price off-shore due to moisture content present at the time of delivery. A part of similar inventory is included in Rs.20 crores.*
- (b) *The company has suffered a net loss for the year. The directors however declared and paid an interim dividend @ 30% based on the half-yearly performance.*

Answer

- (a) **Valuation of Damaged Inventory:** A part of the inventory exported earlier had to be sold at a discounted price off shore due to moisture content present at the time of delivery. The auditor will therefore have to examine what part of the inventory is included in the inventory valued at Rs.20 crores, a part of which had been exported at a discounted price. He will also have to satisfy himself that whether such part left with the company has also been damaged on account of moisture content. If required, the auditor may obtain a certificate from an expert about the condition of the inventory. Thereafter, it should be verified whether the principle of valuation enunciated in AS 2 (Revised) "Valuation of Inventories" have been followed in such a case. The standard requires that the inventories should be valued at the lower of cost or net realisable value. AS 2 (Revised) defines the net realisable value as the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. Accordingly, such part of inventory which is damaged should be valued at estimated realisable value if the same is lower than the cost. In the present case the auditor shall satisfy himself whether the balance inventory lying with the company is carrying the same quality issue. If yes, than value of inventory will be revised based on the past performance as per its net realisable value.
- (b) **Declaration of Interim Dividend:** Interim dividend can be declared by the Board of Directors only if there is an authorisation in the Articles of Association to do so. An interim accounts should be prepared to ascertain the amount of profits that has been made. Assuming that interim accounts have been prepared and they disclose profits sufficient for the declaration of dividend after making appropriate provisions for depreciation, compulsory transfers to reserves, bad debts and other contingencies, only then the proportion of profits which have to be distributed as interim dividend may be decided.

In the present case, the company has suffered a net loss at the end of the year, obviously the directors have miscalculated the performance of the company about the second half of the year. If the company had a sufficient balance in the profit and loss account as at the beginning of the year, the dividend declared could be paid out of the same. The balance had also to be sufficient to transfer the relevant amounts to reserves.

In such a case the auditor need not report anything. Moreover, if such balance was not available, the dividend could also be paid out of reserves. In the situation of dividends to be declared out of reserves, a maximum of only 10% dividend is allowed. In this case, since the dividend was declared @ 30%, the said provisions would have been violated and thus the auditor would have to mention the said fact. If, however, there is no balance in the profit and loss account nor any reserves were available, the dividend would be clearly paid out of capital. The auditor would have to qualify his report mentioning the fact of the dividend having been paid out of capital.

Question 6

Y Ltd. has accumulated losses of Rs.12 crores. The Reserves and Surplus of the said company also include "Securities Premium Account" of Rs. 15 crores. The company intends to adjust the accumulated losses against the "Securities Premium Account". Is the company permitted to do so under the provisions of the Companies Act, 1956?

Answer

Section 78 of the Companies Act, 1956 deals with the application of premium received on issue of securities. Sub-section (1) of the said section provides that where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to an account, to be called "the securities premium account"; and the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this section, apply as if the securities premium account were paid-up share capital of the company.

Sub-section (2) of the said section provides that notwithstanding anything in sub-section (1), be applied by the company—

- (a) in paying up unissued shares of the company to be issued to members of the company as fully paid bonus securities;
- (b) in writing off the preliminary expenses of the company;
- (c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; or
- (d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

In view of the above provisions of the Companies Act, 1956, the company is not permitted to adjust its accumulated loss against the Securities Premium Account.

Question 7

Write a short note on - Capital Reserves.

Answer

Capital Reserves: The expression 'reserve' has been defined in Part III of Schedule VI to the Act as not including "any amount written off or retained by way of providing for depreciation,

renewals or diminution in the value of assets or retained by way of providing for any known liability". A reserve may be 'capital reserve' or 'revenue reserve'. The term "capital reserve" has not been defined in the Companies Act, 1956 except in a negative way in Part-III of Schedule VI to the Act. The expression "capital reserve" shall not include any amount regarded as free for distribution as dividend through the Profit and Loss Account. Capital reserve is created out of profits of a capital nature. Premiums issued on the issue of shares and debentures, profit made on redemption of debentures and the balance standing to the credit of forfeited shares account after re-issue of forfeited shares are some of the examples of capital reserve. In fact, capital reserves are in the nature of capital receipts which also cannot be distributed as dividends at all. AS 12, "Accounting for Government Grants" provides that where the grant relates to a non-depreciable asset, e.g., freehold land, and it has been decided that gross value of fixed asset should not be touched it should be generally be credited to capital reserve.

Question 8

As an auditor, state your view on the following:

- (a) *M Ltd. manufactures machinery used in Steel Plants. It quotes prices in various tenders issued by Steel Plants. As per terms of contract, full price of machinery is not released by the steel plants, but 10% thereof is retained and paid after one year if there is satisfactory performance of the machinery supplied. The company accounts for only 90% of the invoice value as sales income and the balance amount in the year of receipt to the extent of actual receipts only.*
- (b) *A Public Company defaulted in the repayment of deposits together with interest on the due date for more than a year and the Chief Accountant contends that the auditor need not report on the default committed by the company*

Answer

- (a) **Recognition of Revenue:** AS 9 on 'Revenue Recognition', states that revenue from sale of goods should be recognised when the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership and no significant uncertainty exists regarding the amount of consideration. In the case of M Ltd., the goods, as well as the risks and rewards of ownership have been transferred to the steel plants. The invoice raised by M Ltd. is for the full price, but 10% less is received as the same is kept as 'Retention Money'. In this case, therefore, revenue has to be recognised at the full invoice price, i.e., 100% has to be accounted as Sales Income. Depending on the past experience of recovering the balance 10% from the steel plants, M Ltd. can, however, keeping in view its past performance make a provision for sales income which is not likely to realise. In the absence of the above, the auditor will have to qualify his report.

- (b) **Default in Repayment of Deposits and Auditor's duties:** The auditor's reporting requirements are contained in section 227 of the Companies Act, 1956. As far as requirements relating to deposits are concerned: CARO 2003, issued under section 227 of the Companies Act, 1956; and, clause (f) of Section 227(3) read with section 274 (1) (g) require auditor to specifically report on this aspect. Hence, the contention of the chief accountant is not correct. Under Clause (f) of section 227(3) of Companies Act, 1956 the auditor has to report whether any director is disqualified from being appointed as a director under clause (g) of sub-section (1) of section 274.

The relevant extracts of section 274(1) (g) referred to in clause (f) of section 227 (3) of the Companies Act, 1956 are as follows:

"A person shall not be capable of being appointed director of the company, if

(g) such person is already a director of public company which:

(A) -----

(B) has failed to repay its deposits or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more; provided that such person shall not be eligible to be appointed as director of any other public company for a period of five years from the date on which such public company in which he is a directorhas failed to repay its deposits or interest or redeem its debentures on due date or pay dividend referred to in Clause B".

On a perusal of section 227(3)(f) it is apparent that the auditor has to report upon whether any of the directors of the public company, are disqualified from being appointed as a director in terms of clause (g) of sub-section (1) of section 274.

In addition, the CARO under section 227(4A) of the Companies Act, 1956 under Para (vi) has to state whether in case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India and the provisions of sections 58A, 58AA or any other relevant provisions of the Act and the rules framed there under, where applicable, have been complied with. If not, the nature of contraventions should be stated; if an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal whether the same has been complied with or not?

In view of the above two situation, the auditor is required to make a report on defects committed by the company.

Question 9

- (a) *Following is the data regarding six segments of Z Ltd.:*

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	(Rs. in '000s)					
Particulars	A	B	C	D	E	F
Segment Revenue (Rs.)	150	310	40	30	40	30
Segment Result (Rs.)	25	(95)	5	5	(5)	15
Segment Assets (Rs.)	20	40	15	10	10	5

The Finance Director is of the view that it is sufficient that segments A and B alone be reported. Advise

- (b) Y Ltd. wishes to obtain a machine tool costing Rs.20 lakhs by way of lease. The effective life of the machine tool is 12 years but the company requires it only for the first five years. It enters into an agreement with R Ltd. for a lease rental of Rs.2 lakhs p.a.

The Finance Director of Y Ltd. is not sure about the treatment of these lease rentals and hence requests your assistance in proper disclosure of the same. For calculation purposes, the implicit rate of interest may be taken at 15%. Discount factors : 0.87, 0.76, 0.66, 0.57 and 0.50.

Answer

- (a) As per AS 17 on 'Segment Reporting', "a business segment or geographical segment should be identified as a reportable segment if:
- (i) its revenue from sales to external customers and from transactions with other segments is 10% or more of the total revenue, external and internal of all segments, or
 - (ii) its segment result, whether profit or loss, is 10% or more of:
 - (a) the combined result of all segments in profit ; or
 - (b) the combined result of all segments in loss, whichever is greater in absolute amount; or
 - (iii) its segment assets are 10% or more of the total assets of all segments.

AS 17 also requires that if total external revenues attributable to reporting segments constitute less than 75% of the total enterprise revenue, additional segments should be identified even if they do not meet 10% criteria.

On the basis of the above the following conclusions emerge:

- ◆ Segmental Revenue – A and B will be reportable segments since both these segments 10% or more of total revenue i.e., Rs. 6,00,000
- ◆ Segmental Results – A, B and F will be reportable segments since the result of these segments is 10% or more than (Rs. 1,00,000) the combined results of segments in loss.

- ◆ Segment assets – A,B,C, D and E will be the reportable segments since there are 10% or more if total segmental assets i.e. Rs. 1,00,000. Hence all the segments have to be reported.
- (b) The fair value of asset is Rs.20 lacs and the present value of lease rentals is 6.72 lacs. The machine is required for five years only which is less than 50% of the economic life. In view of having regard to substance of the transaction on both were courts, as per AS 19 on Leases, the lease will be classified as an operating lease. As per AS 19, the following may be disclosed:

Future minimum lease payments – Not later than 1 year	Rs. 2 lacs
Future minimum lease payments – Later than 1 year and not later than 5 years	Rs.4.98 lacs

Question 10

Write a short note on - Divisible profits.

(4 marks) (Final May 2002)

Answer

Divisible Profits: Divisible profits are profits available for distribution to shareholders as dividends. It is different from book profit or economist's concept of profit. It represents those profits which are legally available for distribution as dividends.

Section 205 prohibits a company from declaring dividends out of its profits before providing for depreciation in the manner laid down in the section. Depreciation should be provided as per rates/methods prescribed in Schedule XIV of the Act; not only for the year for which dividend is declared but also in respect of preceding financial year or years [since the commencement of Companies (Amendment) Act, 1960] for which adequate depreciation had not been provided in the books. If a loss has been incurred in the past which remains debited in the accounts then the amount of loss or the amount of depreciation whichever is less should be provided in the books before any dividend is declared.

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

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

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

Question 11

As a statutory auditor for the year ended 31st March 2010, how would you deal with the following:

P Ltd. has filed a petition in the High Court for adjustment of product development expenses of Rs.50 crores against the balance in Securities Premium account. While finalizing the accounts, the directors carried out the said adjustment since they were certain that the High Court approval would be received. The said petition has not come up for hearing till the date of signing of the accounts by the auditor.

Answer

Adjustment of Product Development Expenses against Balance in the Securities Premium Account: Product development expenses are normally classified as revenue expenditure. In the instant case, the company adjusted the said expenses with the balance standing in the Securities Premium Account. Such an accounting treatment is not possible having regard to the normally acceptable accounting principles. However, any adjustment that is approved by the High Court will override the normally acceptable accounting principles. In the instant case, though the company has filed a petition in the High Court for carrying out the above adjustment, and though the directors are certain that the High Court would approve the adjustment, the said petition has not been finalised or approved by the High Court till the date of signing of accounts. In view of the same, the company cannot carry out the said adjustment. The statutory auditor, therefore, will have to qualify his report by stating that the product development expenses have been adjusted against the Securities Premium Account rather than treating them as the revenue expenditure and writing it off to the Profit and Loss Account. The statutory auditor would also have to mention the amount by which the profit for the year has been overstated.

[Students may refer Section 78 of the Companies Act, 1956 to specify the areas where the Securities Premium can be used]

Question 12

As a statutory auditor, how would you deal with the following:

- (a) *XYZ Ltd., as part of overall cost cutting measure announced voluntary retirement scheme (VRS) to its employees, to reduce the employee strength. During the first half year ended 30.9.2002 the company paid a compensation of Rs.72 lakhs to those who availed the scheme. The Chief Accountant has reflected this payment as part of regular salaries and wages paid by the company. Is this correct?*

- (b) *During the course of statutory audit of an investment company dealing in shares and securities, in spite of repeated reminders by the statutory auditor, the company officials did not provide the investments held by the company at the Balance Sheet date for verification and also did not provide the details for valuation of unlisted shares as on the Balance Sheet date. The statutory auditor, in his final audit report to the shareholders, reported as follows:*

“Subject to the verification of the existence and value of the investments, the Balance Sheet shows a true and fair view.”

Is the report made by the Statutory auditor correct?

Answer

- (a) **Accounting Treatment of Payment on account of VRS:** As per AS 5, “Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies” the payment made to its employees on account of VRS as an overall cost cutting measure would fall in the ambit of ordinary activities connected with the business of the enterprise. AS 5 requires that when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. In fact an activity like VRS can very well be treated as restructuring exercise carried by the enterprise. Though this is not an extraordinary item, AS 5 requires that items of income and expense which are not extraordinary items, the nature and amount of such items may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. Disclosure of such information is sometimes made in the notes to the financial statements.

Considering the above, the compensation of Rs. 72 Lakhs paid towards VRS availed by employees should be shown separately in the profit and loss account of XYZ Ltd., so that the effect of it on the operating results of the Company during the previous year can be perceived. Therefore, clubbing of Rs. 72 lakhs with the regular salaries and wages of the company by the Chief Accountant is not appropriate and, thus, the separate disclosure is necessary.

- (b) **Failure to Obtain Information and Explanation:** The statutory auditor is required to express his opinion on the truth and fairness of financial statement audited by him only after examining the authenticity with reference to the information and explanations given to him. He must determine the extent of information which should be obtained by him before he expresses his opinion on the financial statement submitted to him for report. He should not express an opinion before obtaining the required data and information. In the given case, since the statutory auditor did not see the existence and also valuation of the investments held by the investment company the auditor, should not say “Subject to the verification of the existence and value of the investments, the balance sheet shows a

true and fair view." In fact, as per facts given in the question, the auditor has not been able to obtain information and might not be able to satisfy himself by adopting other audit procedure and accordingly may have to appropriately modify the report. The auditor may state that because of these circumstances, he has been unable to form an opinion. But, reporting by the auditor that, "subject to verification of the existence and value of the investments, the balance sheet shows a true and fair view", the auditor is not providing information but only means to information. The situation in this case is analogous to London and General Bank's case. By reporting in the above manner auditor is not conveying any information. Rather, the auditor is arousing the suspicion of users of financial statements. Section 227(3) requires the auditor to specifically, state whether or not he has obtained all such information and explanation. If the auditor has not been able to obtain relevant information or explanations, he may have to qualify his opinion on the truth and fairness of the financial statements or express his inability to give an opinion in the matter. Thus the auditor has failed to perform his responsibilities

Question 13

As a Statutory Auditor, how would you deal with the following cases?

- (a) *During the course of audit of ABC Ltd. it is noticed that out of Rs. 12 lakhs of provident fund contribution accounted in the books, only Rs. 2 lakhs has been remitted to the authorities during the year. On enquiry the Chief Accountant informed that due to financial problems they have not remitted but will remit the same as and when the position improves.*
- (b) *M/s LNK's group gratuity scheme's valuation by actuary shows wide variation compared to the previous year's figures.*
- (c) *In the books of accounts of M/s OPQ Ltd. huge differences are noticed between the control accounts and subsidiary records. The Chief Accountant informs that this is common due to huge volume of business done by the company during the year.*

Answer

- (a) **Depositing Provident Fund Dues:** The Companies Audit Report's Order, 2003 required the auditor to state whether the undisputed dues of provident fund have been regularly deposited 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 date they became payable, shall be indicated by the auditor.*

In this case there is a default in not depositing the provident fund contribution to the extent of Rs. 10 lakhs which is a lapse on the part of the company. The reason put forward by the Chief Accountant that the amount has not been deposited due to financial problems faced by the Company is no excuse for not remitting the provident fund. In fact, the company has not at all been regular in depositing the amount. Thus, the auditor shall include this in his report indicating the extent of arrears.

- (b) **Valuation by Actuary:** SA 620, "Using the Work of an Expert" states that the auditor has to evaluate the work of an expert, say, actuary, before adopting the same. This becomes more crucial since M/s LNK's group gratuity scheme's valuation by actuary shows wide variation compared to previous year figures. There is no doubt that appropriateness, reasonableness of assumptions and methods used are the responsibility of the expert, but the auditor has to determine whether they are reasonable based on the auditor's knowledge of the client's business and result of his audit procedures. In the present case, the auditor must verify the reasonableness of assumptions made and methods adopted by the actuary in the evaluation particularly with reference to factors such as rate of return on investments, retirement age, number and salary of employees, etc. Accordingly, the auditor has to satisfy himself whether valuation done by the actuary can be adopted, otherwise he may report on his findings for wide variation.
- (c) **Difference between Control Accounts and Subsidiary Records:** The huge differences found between control accounts and subsidiary records in the books of M/s OPQ Ltd. indicate that there may be material misstatements requiring detailed examination by the auditor to ascertain the cause. The contention of Chief Accountant cannot be accepted simply because the company has done huge volume of business. Such a phenomenon indicates that recording of transactions is not being done properly or the accounting system in the company which might have several branches spread over the country fails to capture all transactions in time. It would also be interesting to see whether it is a recurring phenomenon or such reconciliation could not be done at a subsequent date. Having regard to all these circumstances, it appears from the facts of the case that these differences indicate the possibility of some kind of material misstatements. Further, when the auditor encounters circumstances that there is material misstatement, the auditor should perform procedures to determine whether the financial statements are materially misstated. If as a result of such examination the auditor comes across any material information involving fraud or gross irregularity the same shall be reported by him appropriately.

Question 14

As a Statutory Auditor, how would you deal with the following?

The accountant of C Ltd. has requested you, not to send balance confirmations to a particular group of debtors since the said balances are under dispute and the matter is pending in the Court.

Answer

External Confirmation Requests: SA 505, "External Confirmations", establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. It requires that the auditor should employ external confirmation procedures in consultation with the management. The auditor may come across certain situations in which the management may request him not to seek external confirmation from certain parties because of dispute with the debtors, etc. The management, for example, might make such a request on the grounds

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that due to a dispute with the particular debtor, the request for confirmation might aggravate the sensitive negotiations between the entity and the debtor.

In such cases, when an auditor agrees to management's request not to seek external confirmation regarding a particular debtor, the auditor should consider validity of grounds for such a request and assess management's integrity and obtain evidence to support the same. The auditor should also ask the management to submit its request in a written form, detailing therein the reasons for such a request.

If the auditor agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should document the reasons for acceding to the management's request and should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter.

While considering the validity of request, in case the auditor reaches at a conclusion that the same was not valid, he may appropriately modify the report.

Question 15

When can a company be said to have 'Not maintained' proper books of account? What is the role of the statutory auditor for the same?

Answer

Section 209(1) of the Companies Act, 1956 requires that every company shall keep proper books of account with respect to the following items:

- (i) all sums of money received and expended by the company and the matters in respect of which the receipts and expenditure take place;
- (ii) all sales and purchases of goods by the company;
- (iii) the assets and liabilities of the company; and
- (iv) in the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilisation of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particulars in the books of account.

Proper books of account shall not be deemed to be kept if such books of accounts are not kept on accrual basis of accounting and according to double entry system of accounting. . In addition, proper books of accounts should be made following the accounting standards.

In case proper books of account are not kept, the auditor is required to specifically refer to violation of the section 227(3) Companies Act, 1956 in the auditor's report and shall also state that in his opinion proper books of account as required by law have not been kept by the company so far as appears from his examination of those books and, he has to further give either qualified opinion or disclaimer of opinion.

Further, the books also have to be maintained under accrual system. If the statutory auditor finds the books not maintained or are not maintained properly, he will have to modify his report.

Question 16

Write short notes on the following:

- (i) *Consolidated Financial Statements*
- (ii) *Audit Committee*
- (iii) *Remuneration to Statutory Auditors under the Companies Act, 1956.*

Answer

- (i) **Consolidated Financial Statements:** The Council of the Institute of Chartered Accountants of India has issued Accounting Standard (AS) 21 'Consolidated Financial Statements' which lays down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated financial statements are presented for a group of entities under the control of a parent. A 'parent' is an entity that has one or more subsidiaries. A group comprises a parent and its subsidiaries. Thus, consolidated financial statements are the financial statements of a group presented as those of a single entity. AS 21 is applicable to a parent that presents consolidated financial statements. In other words, whenever a parent decides to prepare and present consolidated financial statements, it should do so in accordance with the requirements of Accounting Standard (AS) 21, Consolidated Financial Statements.

Consolidated financial statements normally include consolidated balance sheet, consolidated statement of profit and loss, and notes, explanatory material that form an integral part thereof, and also consolidated cash flow statement (in case a parent presents its own cash flow statement). Consolidated financial statements are presented, to the extent possible, in the same format as adopted by the parent for its separate financial statements.

An entity which prepares the consolidated financial statements, either under any law or regulation governing the entity or suo motu, might be required to or otherwise engage a member for conducting the audit of consolidated financial statements.¹ The auditor of the consolidated financial statements may not necessarily be the auditor of the

¹ The Securities and Exchange Board of India, vide its circular SMDRP/Policy/Cir.44/01 dated August 31, 2001 has amended clause 32 of the listing agreement which now requires the listed companies to publish consolidated financial statements in addition to the separate financial statements in its annual report. The amended clause further requires that the statutory auditors of the company should audit the consolidated financial statements. The filing of consolidated financial statements with stock exchanges has also been made mandatory.

Similarly, the Reserve Bank of India, vide its circular no. DBOD No. BP.BC. 72/21.04.018/2001-02 dated February 25, 2003 have required the banks to prepare consolidated financial statements to facilitate consolidated financial supervision.

separate financial statements of the parent or one or more of the components² included in the consolidated financial statements. However, a law or regulation governing the entity may require the consolidated financial statements to be audited by the statutory auditor of the entity. This Guidance Note provides guidance on the specific issues and audit procedures to be applied in an audit of consolidated financial statements.

(ii) Audit Committee

An audit committee is a committee of the board of directors of a company entrusted with the task of overseeing the financial process of the company. This committee will consider various issues relating to the audit functions and review the company's financial and risk management policies. Audit committees have received wide publicity and there is a growing awareness of the benefits of these committees. That an effective audit committee can make a significant contribution to the financial reporting process of a company has been well recognised. Though an audit committee may be considered as an extended arm to assist in accomplishing board's objectives, it has very strong impact on all major groups related to the financial reporting process, viz., the board of directors, the managerial personnel and the independent auditor.

Primarily, an effective audit committee is a positive step as it strives to enhance the credibility and integrity of financial statements. In this process, the following related benefits accrue as well:

- (i) It helps board of directors to discharge their ever-increasing responsibilities in an efficient and effective manner with due care and diligence. Thereby, it reduces the burden of top management.
- (ii) It facilitates greater personal involvement by directors' especially non-executive directors in financial and audit aspects of the company.
- (iii) An effective committee is also concerned to determine whether or not to appoint statutory auditor for non-audit services as well. Thus, it reinforces the auditor's independence in general.
- (iv) By monitoring and evaluating the results of internal audit, it can suggest overall improvement in the internal controls.
- (v) By an objective review of management's financial policies including accounting policies and operations, it provides a stimulus for optimal performance by the management.

The formation of an audit committee is a relatively simple matter, but rendering it effective is more complex. A single most important factor is the attitude of the top

² Paragraph 8 of SA 600, Using the Work of Another Auditor defines "components" as a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by the principal auditor.

management towards such committees. The success of a committee depends upon the selection of members who are not only competent enough to deal with technical matters but should also have enough time to devote in order to fulfil their role. This may also lead to increase in costs.

Note:[Not part of the Answer]

Section 292A of the Companies (Amendment) Act, 2000 applicable w.e.f. 13-12-2000 provides for constitution of audit committees is reproduced below for the information of students.

- (i) Every public company having paid-up capital of not less than five crores of rupees shall constitute a committee of the Board known as "Audit Committee" which shall consist of not less than three directors and such number of other directors as the Board may determine of which two-thirds of the total number of members shall be directors, other than managing or whole-time directors.
- (ii) Every Audit Committee constituted under sub-section (1) shall act in accordance with terms of reference to be specified in writing by the Board.
- (iii) The members of the Audit Committee shall elect a chairman from amongst themselves.
- (iv) The annual report of the company shall disclose the composition of the Audit Committee.
- (v) The auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the Audit Committee but shall not have the right to vote.
- (vi) The Audit Committee should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review the half-yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems.
- (vii) The Audit Committee shall have authority to investigate into any matter in relation to the items specified in this section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary.
- (viii) The recommendations of the Audit Committee on any matter relating to financial management, including the audit report, shall be binding on the Board.
- (ix) If the Board does not accept the recommendations of the Audit Committee, it shall record the reasons therefor and communicate such reasons to the shareholders.
- (x) The Chairman of the Audit Committee shall attend the annual general meetings of the company to provide any clarification on matters relating to audit.

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- (xi) If a default is made in complying with the provisions of this section, the company, and every officer who is in default, shall be punishable with imprisonment for a term which may extend to one year, or with fine which may extend to fifty thousand rupees, or with both.

(iii) Remuneration to Statutory Auditors under the Companies Act, 1956: Under Section 224(8) of the Act, it is fixed:

- (a) in case of an auditor appointed by the Board or the Central Government, may be fixed by the Board or the Central Government as the case may be; and
- (b) subject to clause (a) above, shall be fixed by the company in General meeting or in such manner as the company in general meeting may determine. For this purpose, the expression "remuneration" should be deemed to include any sums paid by company in respect of the auditor's expenses.

Students may note that the Act does not require that the remuneration should be fixed at the same meeting of the company at which the appointment is made. It may, therefore, be fixed at a subsequent meeting. Where a retiring auditor has been re-appointed, his remuneration in the absence of any resolution fixing a different remuneration is considered to be the amount already fixed, in respect of the previous appointment. Where, in addition to the normal audit, the auditor is also required to undertake the writing up of the books, to prepare the annual accounts of the company and do the income-tax or secretarial work, he is entitled to receive remuneration in addition to the normal fee for the audit. Such additional remuneration is a matter of arrangement with the directors. But any remuneration paid as fees, expenses or otherwise for such service must be disclosed in the Profit & Loss Account. The remuneration paid to the auditor is required to be shown in the Profit & Loss Account separately:

- (a) as auditor;
- (b) as adviser or in any other capacity in respect of:
 - (i) taxation;
 - (ii) company law matters;
 - (iii) management service; and
- (c) in any other manner.

The Council of the Institute of Chartered Accountants of India in the 'Statement on Payment to Auditors for other Services' has recommended that the fees paid to the auditors for other services rendered should be disclosed in the profit and loss account of the companies under the following heads in order to give precise and correct information to shareholders and others who read the accounts:

- (i) tax representation;
- (ii) company law matters;

- (iii) management services;
- (iv) internal auditing;
- (v) other services.

In case of joint audit, if other services were rendered by one of the joint auditors or in case of a company having a branch, the other services were rendered by the branch auditor, a disclosure should be made accordingly.

Section 224(8)(aa) has been inserted whereby it is provided that, in the case of an auditor appointed under section 619 by the Comptroller and Auditor General of India, the remuneration shall be fixed by the company in a general meeting or in such manner as the company in general meeting may determine. Earlier this power was vested in the Central Government.

Question 17

Write a short note on - Personal Expenses of Directors.

Answer

Personal Expenses Of Directors: Payments to directors by way of remuneration and perquisites are required to be authorised in accordance with sections 198 and 309 of the Companies Act, 1956. Depending upon the requirements of Articles of Association of the company, the remuneration may require sanction of the shareholders either by special resolution or ordinary resolution or only approval of the Board. If terms of appointment include payment of expenses of personal nature then the company can incur such expenses. If there is no provision to incur personal expenses and if such expenses are incurred, then it is the duty of the auditor to point out such expenses in the report. Reporting requirements "the requirement of identifying and reposting on personal expenses" has been dispensed with in CARO, 2003.

Question 18

You have been appointed the sole statutory auditor of a company where you were one of the joint auditors in the immediately preceding year. The concerned joint auditor has not been reappointed. What are the various steps you would take to ascertain the compliance of the requirements of the Companies Act, 1956 before accepting the audit?

Answer

Compliance with Requirements of Companies Act, 1956: When one of the joint auditors of the previous year is appointed as the sole auditor for the next year, it is similar to new re-appointment of one of the retiring joint auditors. The provisions of section 225 of the Companies Act, 1956, relating to non-reappointment of the other person also need to be considered. The following points should be taken into account:

- (i) Special notice u/s 225(1) was duly received by the company from a member at least 14 days before AGM containing a proposal for appointing a sole auditor expressly.
- (ii) Verify notice sent to all the members at least 7 days before the AGM. [u/s 190(2)]

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- (iii) Verify that special notice has been sent to retiring auditor forthwith. [u/s 225(2)]
- (iii) Any representation received from the retiring auditor was sent to the members [u/s 225(3)].
- (iv) Verify from the minutes whether the representation received from the retiring joint auditor was considered at the AGM.
- (v) Examine that proposed resolution was properly passed.
- (vi) Ensure that provisions of section 224(2) are complied fully.
- (vii) Ascertain special resolution u/s 224A, if any, is passed accordingly.
- (viii) Obtain a certified copy of the relevant minutes of AGM and a written communication of the appointment within 7 days.

Question 19

A company has a branch office, which recorded a turnover of Rs. 1,90,000 in the financial year 2004-05. No audit of the branch has been carried out. The statutory auditor of the company has made no reference of the above branch in his report. The total turnover of the company is Rs.10 crores for the year 2004-05. Comment.

Answer

Section 228 of the Companies Act, 1956 requires that the accounts of a branch office of a company are required to be audited either by the company's auditor or by any other person qualified for appointment as auditor of the company. So, normally speaking, the audit of branch office has to be carried out unless the company has obtained exemption under the Companies (Branch Audit Exemptions) Rules, 1961 formulated u/s 228(4), having regard to quantum of activity. The Rules provide for the exemption of a branch office of a company carrying on manufacturing, processing or trading activity from the provisions of section 228, if the average quantum of activity of the branch does not exceed rupees two lakh or two per cent of the average of the total turnover and the earnings from other sources of the company as a whole, whichever is higher. Since in the instance case, no such exemption has been obtained and accordingly, the company is liable. The auditor is also required to mention this fact in the audit report and deal appropriately.

Question 20

As a Statutory Auditor, how would you deal with the following?

P Ltd. of whom you are the Statutory Auditor appoints M/s XYZ as Branch Auditors for one of its branches. M/s XYZ conducted the audit of the branch without visiting the branch and instead getting the books at the H.O. M/s XYZ has submitted their Branch Audit Report to you.

Answer

Branch Auditor's Report: As per provisions of the Companies Act, 1956, the accounts of a branch office of a company are required to be audited either by the company's auditor or by any other person qualified for appointment as auditor of the company. It is not necessary for branch auditor M/s XYZ to visit the branch and conduct the audit only at branch's premises. It is a matter of professional judgement for the branch auditor to decide as to whether he needs to visit the branch. At the same time, the statutory auditor has the right to visit branch offices and to have access to the books of accounts and vouchers maintained at the branch office in this case.

In any case, the principal auditor i.e. the statutory auditor of Head Office P Ltd is entitled to rely on the work of branch auditor unless there are special circumstances to make it essential for him to visit the branch and examine the books of account and voucher records. As per basic principles governing an audit, the principal auditor is entitled to rely upon 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. As per SA 600, "Using the work of another auditor", the principal auditor is not required to evaluate professional competence because branch auditor happens to be member of ICAI. The statutory auditor is also required to deal with the Branch Auditor's report in the manner, he considers necessary. Therefore, the statutory auditor is required to deal with M/s XYZ's report in the manner it considers fit under the circumstances.

Question 21

As a statutory auditor, how would you deal with the following:

ABC Ltd. having a paid up capital of Rs. 1 crore earned as total net profit of Rs. 1 crore for the years 2007-08 to 2008-09. The Company did not declare any dividend nor transferred any amount to Reserves for these years. The entire profit was retained in the Profit & Loss Account. In 2009-10, the company made a profit of Rs. 20 lacs. The company also proposed in 2009-10 to declare dividend @25% out of accumulated profits.

Answer

Declaration of Dividends: ABC Ltd. earned a total net profit of Rs.1 crore for three years 2007-08 to 2008-09 but it did not declare any dividend nor transferred any amount to Reserves for these three years. Since it did not declare any dividend, there was no compulsion to transfer any amount to Reserves. It appears that the company has retained the profit of previous years as "surplus" under the heading of "Reserves & Surplus". ABC Ltd. wants to declare dividend of Rs. 25 lacs for the financial year 2009-10, which works out to 25% of its paid up capital. However, since this rate of dividend exceeds 20% of the paid up share capital, as per the requirements of Companies (Transfer of Profit to Reserves) Rules, 1975, the company should transfer at least 10% of its current profit that is Rs.2 lacs to reserves resulting into deficiency of Rs. 2 lacs in the amount of current profit which could be available for the purpose of distribution of dividend.

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The company, however, is well within its power to cover the said deficiency of profit out of its accumulated profit in spite of restrictions laid down in the rules prescribed under section 205A (3) of the Act, viz., Companies (Declaration of Dividend out of Reserves) Rules, 1975, since the company had not transferred any of its profit for the years 2007-2008 to 2008-09 to reserves. Thus, the company is well within its powers and right to declare the dividend of Rs.25 lacs for the year 2009-10.

Question 22

As a Statutory Auditor, how would you deal with the following?

- (a) *Mr. Rajesh is appointed as the auditor of NOIDA Travels Ltd. with audit fees of Rs. 35,000. He purchased air ticket from Delhi to Kolkata and back for Rs. 18,000 from the client for his personal work and the amount remains unpaid at the end of the year as it is a general practice of the client to give credit to all. Mr. Rajesh claims that he does not incur any disqualification as contained in Section 226(3)(d) of the Companies Act.*
- (b) *Apex Ltd., a well reputed manufacturing public limited company has made a contribution of Rs. 2.5 lacs during the financial year ended 31.3.06 to a political party for running a school, situated in the village, where most of the workers of the company reside. It is admitted that the benefit of the school is mostly for the children of the workers of the company. The company has not made any profits in the last four years.*

Answer

- (a) **Disqualification of auditors:** The guidance note on “Independence of Auditors” issued by the ICAI in this context recommends that “a question of indebtedness may also be raised where an auditor of a company purchases goods or services from the company audited by him. In such a case, if the amount outstanding exceeds Rs. 1000, irrespective of the nature of the purchase or period of credit allowed to other customers, the provisions concerning disqualification of auditor as contained in sec 226 (3) (d) will be attracted.” This is applicable in the case of purchase of air tickets for personal work by the auditor of a company on normal terms and conditions of the business of the company as the amount outstanding at the end of the year exceeded Rs. 1000. Therefore, the contention of Mr. Rajesh that he does not incur disqualification is not correct as he has purchased a ticket of the value of Rs. 18,000. The provisions concerning disqualifications of auditor as contained in Sec 226 (3) (d) will be attracted.
- (b) **Restrictions regarding political contribution:** Section 293-A of the Companies Act 1956 deals with prohibitions and restrictions regarding political contributions. A non-Government company which has been in existence for not less than three years may contribute any amount or amounts directly or indirectly to any political party or for any political purpose to any person provided that the aggregate of the amounts which may be so contributed by a company in any financial year shall not exceed 5% of its average net profits determined in accordance with the provisions of Sections 349 and 350 during the three immediately preceding financial years. The company in question has not made any

profit in last four years and contributed Rs. 2.5 lacs during the year to a political party for running a school. This is violation of the provisions of Section 293-A of the Companies Act although the children of its workers are benefited. The auditor would have to qualify his report stating the contravention of the provisions of the Companies Act.

Question 23

As an auditor, how would you deal with the following?

- (a) *In the audit of ABC Private Limited, auditor came across cases of payments to Directors, whereby, expenses of a personal nature were reimbursed.*
- (b) *The management of a limited company states that proposed dividend does not represent a liability and hence no provision need to be made-Comment.*

Answer

- (a) **Reimbursement of personal expense of Director:** All payments to Directors as remuneration or perquisites whether in the case of a public or private company are required to be authorised both in accordance with the Companies Act and Articles of Association of the company. Articles may provide that such remuneration require sanction of the shareholders either by ordinary or special resolution while in some cases it may require only approval of Directors. If the terms of appointment of a Director include payment of expenses of a personal nature, then such expenses can be incurred by the company; otherwise, no such expense can be incurred or reimbursed by the company. In the instant case the auditor has to ensure that the above is complied with, without which, if such expenses are paid, he has to disclose the fact in his report, as also in the accounts. In this regard attention is invited to section 227 (1A) (e) of the Companies Act wherein auditor has to inquire into whether personal expenses have been charged to revenue. However, reporting requirements "the requirement of identifying and reposting on personal expenses" has been dispensed with in CARO, 2003.
- (b) **Provision for proposed dividend:** As per the ICAI's Guidance Note "Provision for Proposed Dividend", proposed dividend does not represent a liability, nor does it amount to a provision, pending the approval of the share holders in the general meeting.

Though the format given in schedule VI requires proposed dividend to be shown under 'Current Liabilities and Provisions', it does not mean in fact that the proposed dividend becomes a liability or is necessarily a provision. Part 1 of Schedule VI that prescribes the form of balance sheet requires "proposed dividend" to be shown under 'Provisions' and paragraph 3(xiv) of Part II of the same Schedule requires specific disclosure of the proposed dividend.

It is recommended, that if no appropriation is made, shareholders' attention should be drawn to such fact and the amount should be quantified. The Council, therefore, recommends the fact that provision for proposed dividend has not been made should be

disclosed by means of a note in the accounts. The auditor should refer to the note in his report and make his report subject thereto.

Question 24

A company wants to amend its accounts after the completion of the audit and adoption of the Accounts by the Board, but before circulation to the shareholders. It requires its statutory auditor to report on the amended accounts. State the steps the statutory audit should adopt in such a situation.

Answer

Amendment of accounts after the completion of the audit and adoption of the Accounts by the Board before circulation to the shareholders: This pertains to the manner in which the statutory auditor should report upon amended accounts. The Companies Act does not contemplate the revision of accounts and a further report by the statutory auditor on the amended accounts. At the same time, it is entirely within the competence of the Board of Directors to amend the accounts and resubmit the same to statutory auditors for report before the accounts are placed before the annual General Meeting. The report issued by the statutory auditor on such amended accounts will be in substitution of the report issued before the amendment. Unless all copies of the original accounts and reports are returned to the auditor, such substitution is not possible.

Members, when called upon to issue a report on amended accounts for the same period due to amendments to the accounts, should ensure all copies of the original accounts and reports are returned to him, adequate disclosure about the revision of accounts already reported, appears as a specific note on the amended accounts. If the Statutory auditor is satisfied about the adequacy of disclosure, there may not be any need for him to refer to the revision of balance sheet and/or the profit and loss account in his report otherwise he has to refer to the revision in his report.

Question 25

- (a) *What are the important aspects to be looked into a due diligence review of Cash flow?*
- (b) *What is the meaning of "Small and Medium sized Company" as per the Companies (Accounting Standards) Rules, 2006?*

Answer

(a) Due Diligence review of cash flow

- (i) Review the historical pattern of cash flows of the organization and look for change in trends.
- (ii) See whether the company is able to meet its cash requirements from internal generations/accruals or does it seek outside sources from time to time.

- (iii) Check whether the company honours its commitments to creditors, Government and other stock holders.
 - (iv) Verify the ability of the company to turn its stock into Debtors i.e. sale ability of its products.
 - (v) Ensure that the company follows up with Debtors and that the Debtors collection period is not very large.
 - (vi) Check the ability of the company to deploy its funds in profitable investment opportunities.
 - (vii) Look into the investment pattern of the company, whether they give maximum benefits to the company and are easily realizable.
- (b)** In exercise of the powers conferred by clause (a) of sub-section (1) of section 642 of the Companies Act, 1956 (1 of 1956), read with sub-section (3C) of section 211 and sub-section (1) of section 210A of the said Act, the Central Government, in consultation with National Advisory Committee on Accounting Standards, made the Companies (Accounting Standards) Rules, 2006. As per these rules "Small and Medium Sized Company" (SMC) means, a company-
- (i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;
 - (ii) which is not a bank, financial institution or an insurance company;
 - (iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;
 - (iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and
 - (v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Explanation: For the purposes of this a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Question 26

Write a short note on - Supplementary Audit u/s 619(4) of the Companies Act, 1956.

Answer

Supplementary Audit u/s 619(4) of the Companies Act, 1956: The auditor of a Government company shall be appointed or re-appointed by the Comptroller and Auditor-General of India . The auditor aforesaid shall submit a copy of his audit report to the Comptroller and Auditor-General of India who shall have the right to comment upon, or supplement, the audit report in such manner as

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he may think fit. Any such comments upon, or supplement to, the audit report shall be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

Question 27

As a Statutory Auditor, how would you verify advances against Goods?

Answer

Verification of advances against goods (Banking Companies):

- (i) *Sanction*: Examine the sanction letter, letter of hypothecation and note the important terms and conditions of the advances.
- (ii) *Stock statements*: Verify the quantity and value of goods hypothecated based on the stock statements received from the borrower. Tests check the Godown Register and examine the valuation of goods to ascertain the reasonableness of the same.
- (iii) *Inspection*: Ascertain as to whether the premises of the borrowers are periodically visited by the bank officials to verify the quantity as per the periodic stock statements.
- (iv) *Stock Audit*: See whether the bank has got a system of obtaining stock and receivables audit report in respect of such advances. If so, review the stock audit report and identify adverse comments, if any.
- (v) *Hypothecation/Pledge*: Examine the letter of hypothecation and certificate of registration of charge, in respect of goods pledged with the bank.
- (vi) *Insurance*: Examine the insurance policies for their validity, adequacy etc. and see that policies are in favour of the bank.
- (vii) *Documents of title*: Inspect the documents of title to goods like bill of lading, dock warrant, railway receipts etc to ensure that they are endorsed registered in favour of the bank.
- (viii) *Third party certificate*: Where the hypothecated goods are in possession of third parties, such as clearing and forwarding agents, transporters, bankers, etc. undertaking has been obtained by the bank that they will handover the goods or sale proceeds thereof to the bank only. In such cases, certificate should be obtained by the bank from such third parties regarding quantities on hand, on balance sheet date. The valuation of such goods should be checked by the auditor.

Question 28

What are the steps to be taken by a firm of Chartered Accountant to ensure that its appointment as Statutory Auditor of a Company is valid?

Answer

Validity of appointment as a statutory auditor: *To ensure that the appointment is valid, the incoming auditor should take the following steps before accepting his appointment:*

1. Ceiling limit: Ensure that a certificate has been issued u/s 224 of the Companies Act, so that the total number of company audits held by the firm (including the new appointment) will not exceed the specified number.
2. Resolution at AGM: Verify that at AGM of the Company, a proper resolution is passed. Inspect general meeting minutes book to see that the appointment is duly recorded.
3. Compliance with law: Satisfy that the legal procedure contemplated in Sections 224 and 225 of the Companies Act, dealing with removal of existing auditor, if required, has been followed. Also see whether Section 224A (provision of special resolution in case of companies in which not less than 25% of the subscribed capital of the Company is held by public financial institutions or Government Companies) and Section 619B (in case of a company in which not less than 51 % of the paid up share capital is held by Central / State Government - C&AG appointment) are attracted and complied with.
4. Code of conduct: Communicate with the previous auditor, if any, to ascertain if there are any professional reasons for not accepting the appointment.

Question 29

What are the duties of an auditor regarding disqualification of directors under Section 274(1)(g) of the Companies Act, 1956?

Answer

Clause (g): of sub section (1) of section 274 of Companies Act, 1956 states:

A person shall not be capable of being appointed as director of company if:

Such person is already a director of a public company which -

- (A) has not filed annual accounts and annual returns for any continuous three financial years commencing on and after first day of April, 1999 or
- (B) has failed to repay its deposits or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more.

Provided such a person shall not be appointed as director of any other public company for a period of five years from date on which such public company where he is director has failed to file annual accounts or returns or has failed to repay deposits or redeem debentures on due date or pay dividend.

Auditor is required to report under section 227 (3) (f) of the Companies Act, 1956 to members of respective companies whether any director is disqualified from being appointed as director under clause (g) of section 274 (1) of the Companies Act, 1956 and

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Furnish certificate every year as to whether on the basis of his examination of the books and records of the company any director of the company is disqualified as a director or not.

Auditor to comply with section 227 (3) (f) should obtain a written representation as to:

Names of directors of company during period covered by auditor's report

- (a) particulars of appointment /resignation of such directors
- (b) Submission of form DD-A, required to be submitted by such director.]
- (c) Information of directors contained in register maintained under section 303(1) of Company's Act as update up to date of balance sheet.
- (d) Details of default committed by company under section 274(1).
- (e) If company has committed any default, whether form DD-B submitted by company on the basis of such examination, auditor is required to furnish certificate every year stating whether any director is disqualified for appointment as director.

Question 30

You have been asked by a company to compile financial statements for the purpose of obtaining loan from a Bank. Draft a report to be given to the Management for the same.

Answer

Draft of a Report of an Engagement to Compile Financial Statements - SRS 4410

To.....

On the basis of the accounting records and other information and explanations provided to us by the management, we have compiled, the unaudited balance sheet of(name of the entity) as at March 31, XXXX and the related profit and loss account and the cash flow statement³ for the period then ended.

The management of the _____ (name of the entity) is responsible for:

- (a) Completeness and accuracy of the underlying data and complete disclosure of all material and relevant information to the accountant.
- (b) Maintaining adequate accounting and other records and internal controls and selecting and applying appropriate accounting policies;
- (c) Preparation and presentation of financial statements in accordance with the applicable laws and regulations, if any.
- (d) Establishing controls to safeguard the assets of the entity and preventing and detecting frauds or other irregularities.

³ Where applicable.

- (e) Establishing controls for ensuring that the activities of the entity are carried out in accordance with the applicable laws and regulations and preventing and detecting any non compliance.

The compilation engagement was carried out by us in accordance with the Standard on Related Services (SRS) 4410 , "Engagements to Compile Financial Information", issued by the Institute of Chartered Accountants of India.

The balance sheet and the profit and loss account are in agreement with the books of account. We have not audited or reviewed these financial statements and accordingly express no opinion thereon.

For ABC & Co.

Chartered Accountants

.....

(Name of the accountant and membership number)

Signature
Designation⁴

Date:

Place:

Question 31

As Auditor of Act Fast Ltd. what steps will you take to ensure that the dividend has been paid only out of profit?

Answer

The auditor may take the following steps to ensure that the dividend has been paid only out of profits.

1. Check whether the dividend was declared out of profits arrived at after providing for depreciation.
2. If no depreciation has been provided, ensure that the approval was obtained from the Central Government before declaring dividend.
3. Check whether
 - (i) The depreciation was provided according to provision of section 205(2).
 - (ii) The minimum prescribed amount has been transferred to reserves before declaring any dividend.
 - (iii) Conditions governing transfer of higher percentage is complied with.
 - (iv) A board resolution recommending dividend was passed.
 - (v) Dividend was declared (resolution was passed) only in the Annual General Meeting.

⁴ Partner or Proprietor.

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- (vi) Dividend has been paid in the prescribed manner within 30 days of time to the registered holder or their order.
- (vii) Amount of dividend deposited in a separate bank account within five days from the date of declaration of dividend.
- (viii) Permission of Reserve Bank of India has been obtained for payment to non-resident shareholders before the remittance of dividend to their account.
- (ix) Intimation sent to Stock Exchange in the case of listed company.
- (x) There were any complaints of non payment/delayed payment of dividend and the corrective action taken.

Question 32

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.

Answer

According to SA 240 (Revised) "The Auditor's Responsibilities Relating to Fraud 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 are 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.