

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS
QUESTIONS

Standards on Auditing, Statements and Guidance Notes

1. (a) While conducting the audit of Sunrise Limited, Mr. S the statutory auditor found that the detection risk relating to certain transactions cannot be reduced to acceptable level. As a Statutory Auditor, how would you deal in the given situation?
- (b) As an auditor of public limited company for year ended 31.03.2013, you discovered an error in valuation of inventory, which has material effect on financial statements. Comment with reference to standards on auditing.
- (c) In the course of audit of ABC Ltd., auditor asked the management to provide written representations on certain matters but its management refuses to provide written representations. State auditor's duty in this regard.
- (d) While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?
2. (a) M/s GBC & Co. auditors of Vishu Ltd., accepted a certificate from management to certify the existence and value of machinery as per records as they were unable to get the confirmation that could prove the existence & value of the machinery. State whether acceptance of certificate by GBC & Co. is right approach of the auditors.
- (b) (i) Explain 'Initial Audit Engagements'?
- (ii) Mr. Garg, has been appointed auditor by Raj Ltd. for first time. Explain the procedure he will follow to satisfy about the sufficiency and appropriateness of 'Opening Balances' to ensure that they are free from misstatements, which may materially affect the current financial statements.
- (iii) With reference to (ii) above, how will you draft your audit report, if you are not satisfied about the correctness of opening balances.

Audit Strategy Planning and Programming

3. (a) M/s Sodhi & Associates have been appointed as the auditor of Raheja Ltd. engaged in the business of manufacturing and export of handloom goods. The partner of the firm explains to the audit team that the formulation of audit strategy shall form the basis of audit planning to achieve the audit objectives in the most effective and efficient manner. As head of the audit team, narrate the steps involved in the formulation of audit strategy.
- (b) Management of Aditya Ltd. provided the data to Mr. Raman, the statutory auditor of Aditya Ltd. Mr. Raman wants to perform analytical procedures on the data provided by the management. What are the considerations he would keep in mind while performing analytical procedures on data prepared by the client?

Risk Assessment and Internal Control

4. (a) As auditor of Himanshu Ltd., you would like to limit your examination of account balance tests. What are the control objectives you would like the accounting control system to achieve to suit your purpose?
- (b) In the audit planning process of Sumit Ltd., you would like to consider audit risk at the financial statement level. What are the factors that can influence your decision?

Audit under CIS Environment and Special Audit Techniques

5. (a) M/s Rahul & Sons is maintaining its accounts in computerized environment. Mr. Avinash being auditor of M/s Rahul makkar & Sons wants to use Computer Assisted Audit Techniques (CAATs). What are the factors Mr. Avinash should consider to decide whether it is appropriate to use CAATs or not?
- (b) Being an auditor, how would you draw an audit plan for evaluating the reliability of controls in CIS environment.

The Company Audit and Liabilities of Auditors

6. (a) Y Ltd. provided ₹ 50 lakhs for inventory obsolescence in 2010-2011. In the subsequent years, it was determined that 50% of such stock was in good condition and usable. The company wants to adjust the same through prior period adjustment account as the provision was made in the earlier year. As an auditor, how would you deal in the given situation:
 - (b) The records of the Karan Limited were destroyed in tsunami. During the year the company sold an old machinery for ₹ 50 lakhs. As the records have been destroyed, the auditor is not able to ascertain the details of cost of machinery. State your views as an auditor.
 - (c) 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. State your views as an auditor.
 - (d) XYZ Limited received a grant of ₹ 25 lakhs under the Government's Subsidy Scheme, for acquiring an imported machinery for setting up new plant. The entire grant received is credited to Profit and Loss Account. State your views as an auditor.
7. (a) As an auditor, how would you deal with the following situations:
 - (i) The Reserves & Surplus of Makkar Ltd. includes "Securities Premium Account" of ₹ 10 crores as on 31.03.2012. The company wants to adjust the accumulated loss of ₹ 6 crore and preliminary expenses of ₹ 25 lacs against "Securities Premium

Account". Whether the provisions of Companies Act, 1956 allow for adjustment of accumulated loss & preliminary expenses against "Securities Premium Account"?

- (ii) Mr. Varun is appointed as the auditor of Manali Travels Ltd. with audit fees of ₹50,000. He purchased air ticket from Delhi to Kolkata and back for ₹20,000 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. Varun claims that he does not incur any disqualification as contained in Section 226(3)(d) of the Companies Act.
 - (iii) Apex Ltd., a well reputed manufacturing public limited company has made a contribution of ₹ 2.5 lacs during the financial year ended 31.3.12 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 made sufficient profits in the last four years.
- (b) Write Short Note on:-
- (i) Personal Expenses of Directors.
 - (ii) Divisible Profits.

Liabilities of Auditor

8. Indicate the precise nature of auditor's liability in the following situations and support your views with authority, if any:
- (i) A misstatement had occurred in the prospectus issued by the company.
 - (ii) Certain weaknesses in the internal control procedure in the payment of wages in a large construction company were noticed by the statutory auditor who in turn brought the same to the knowledge of the Managing Director of the company. In the subsequent year huge defalcation came to the notice of the management. The origin of the same was traced to the earlier year. The management wants to sue the auditor for negligence and also plans to file a complaint with the Institute.

Audit Report

9. (a) A Private Limited reports the following position as on 31st March, 2012 :

Paid up capital	30 lacs
Revaluation reserve	5 lacs
Capital reserve	5 lacs
Revenue Reserve	15 Lacs
P&L A/c [Dr. Balance]	6 lacs

The Management of the Company contends that CARO 2003 is not applicable to it. Comment.

- (b) TATA Private Ltd. has granted loan of ₹ 35 crores to Docomo Ltd. a sister concern

and it remains outstanding at the year end. How would you report the fact?

10. PQR Ltd., a listed company engaged in the business of manufacturing of cycles at two plants, one at Ludhiana and the other at Sonapat and having average annual turnover of more than ₹ 5 crores has no Internal Audit System. Give your views.

Audit of Banking Company

11. (a) M/s SAM & Co. has been appointed as an auditor of a nationalized bank. The records of the bank have some inter branch adjustments. Being an auditor what are the points which require special attention.
- (b) Explain the reversal of Income in case of Banks.
- (c) Ms. Richa has been appointed as an auditor of branch of SBI. She wants to know the aspects which will be considered while reporting on credit appraisal, sanctioning/disbursement and documentation in respect of advances in the LFAR. Suggest.

Audit of General Insurance Company

12. (a) Mr. Aman has been appointed as an auditor of Secure Insurance Company Ltd. What steps should be taken by Mr. Aman for the audit of re-insurance ceded?
- (b) M/s Madaan & Co. has been appointed as statutory auditor of an insurance company. As per the directions under Section 619(3)(A) of the Companies Act, 1956 applicable to Insurance Companies, what are the points on which M/s Madaan & Co. has to report on in respect of System of Accounts?

Audit of Co-operative Societies

13. (a) Your firm has been appointed as an auditor of a Co-operative Society. Being an audit partner list the special features involved in the audit of a Cooperative Society.
- (b) An auditor of a Cooperative Society governed by Cooperative Societies Act, 1912 is required to attach schedules giving certain information. Please list the information required to be given in the schedules.

Audit of Non Banking Financial Companies

14. (a) Enumerate the verification procedures in relation to audit of a Hire-Purchase Finance Company.
- (b) You are the auditor of SLR Ltd., a NBFC registered with RBI. What is the procedure you would follow to ensure that the Prudential Norms have been complied by SLR Ltd.

Audit under Fiscal Laws

15. (a) While conducting the tax audit of Abhishek & Co. you observed that it made an escalation claim to one of its customers but which was not accounted as income. What is your reporting responsibility?
- (b) State whether a Tax audit report can be revised and if so state those circumstances.

- (c) As the tax auditor of a non-corporate entity u/s 44AB of the Income-tax Act, 1961, how would you ensure compliance of section 145 of the Income-tax Act, 1961?

Cost Audit

16. (a) "A cost auditor checks the cost accounting records to verify that the cost statements are properly drawn up as per the records and that they present a true and fair view of the cost of production and marketing of various products dealt with by the undertaking". Comment
- (b) "Like every other audit, a systematic planning for cost audit is also necessary". Indicate the matters to be included in a Cost Audit Programme.

Internal Audit, Management and Operational Audit

17. (a) As an External auditor of Sehgal Enterprises Ltd., explain the important aspects to be considered in the evaluation of Internal Audit Function.
- (b) DLF Ltd., a manufacturing unit does not accept the recommendations for improvements made by the Operational Auditor. Suggest an alternative way to tackle the hostile management.

Investigation and Due Diligence

18. Fertichem Ltd. a company engaged in manufacturing of chemicals is consistently recording higher sales turnover, but declining net profits since the last 5 years. You are appointed to find out the reason for the same. What are the points you would verify?

Professional Ethics

19. Comment on the following with reference to the Chartered Accountants Act, 1949, and Schedules to the Act:
- (a) Mr. Angad, a chartered accountant in practice takes up the appointment as managing director of a public limited company.
- (b) S, a practicing chartered accountant has to go out of town and to meet the work requirements gives power of attorney to an employee chartered accountant to sign reports and financial statements, on his behalf.
- (c) A practicing Chartered Accountant was appointed to represent a company before the tax authorities. He submitted on behalf of his clients certain information and explanations to the authorities, which were found to be false and misleading.
- (d) AB & Co., a firm of Chartered Accountants, included the name of P as a partner while filing an application for empanelment as auditor for Public Sector bank branches. It was subsequently noticed that on the date of application, P was not a partner with AB & Co.

Other Miscellaneous Chapters

20. Write short notes on the following:

- (a) Constitution and functions of Audit Committee under Section 292A of the Companies Act, 1956.
- (b) Contract notes.
- (c) Areas of propriety audit under Section 227(1A) of the Companies Act, 1956.
- (d) Collection of evidences by Peer reviewer.

SUGGESTED ANSWERS/HINTS

1. (a) SA 315 and SA 330 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" and "The Auditor's Responses to Assessed Risks" establishes standards on the procedures to be followed to obtain an understanding of the accounting and internal control systems and on audit risk and its components: inherent risk, control risk and detection risk. SA 315 and SA 330 require that the auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. "Detection risk" is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material. The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures. When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. The auditor should use his professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. If it cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate.
- (b) SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", requires that if circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate. SA 240 also requires that when the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence

.Further, SA 320 also requires that in such circumstances, the auditor should consider requesting the management to adjust the financial information or consider extending his audit procedures. If the management refuses to adjust the financial information and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should express a qualified or adverse opinion, as appropriate. In the instant case, the auditor has detected the material errors affecting the financial statements; the auditor should communicate his findings to the management on a timely basis, consider the implications on true and fair view and also ensure that appropriate disclosures have been made.

- (c) As per SA 580 (Revised) "Written Representations", if the management does not provide one or more of the requested written representations, the auditor shall:
- (i) Discuss the matter with management
 - (ii) Re-evaluate the Integrity of the management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general and
 - (iii) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

The auditor should disclaim an opinion on the financial statements if management does not provide written representations.

- (d) As per SA 530(Revised) "Audit Sampling", sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions.
- (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of tests of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
 - (ii) In the case of test of controls, the controls are less effective than they actually are, or in the case of tests of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.
2. (a) The physical verification of fixed assets is the primary responsibility of the management. The auditor, however, is required to examine the verification programme adopted by the management. He must satisfy himself about the existence, ownership and valuation of fixed assets. In the case of Vishu Ltd., the auditor has not been able to verify the existence and value of some machinery despite the verification procedure followed in routine audit. He accepted the

certificate given to him by the management without making any further enquiry. As per SA 580, when representation relate to matters which are material to the financial information, then the auditor should seek corroborative audit evidence for other sources inside or outside the entity. He should evaluate whether such representations are reasonable and consistent with other evidences and should consider whether individuals making such representations can be expected to be well informed on the matter. "Written Representations" cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. If the auditor is unable to obtain sufficient appropriate audit evidence that he believes would be available regarding a matter, which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter. Therefore, the approach adopted by the auditor is not right.

- (b) (i) As per SA 510 'Initial Audit Engagements - Opening Balances' initial audit engagement is an engagement in which either:
 - (i) The financial statements for the prior period were not audited; or
 - (ii) The financial statements for the prior period were audited by a predecessor auditor
 - (ii) If the prior period's financial statements were audited by a predecessor auditor, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated
 - (iii) If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate. Further, If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion
3. (a) Audit strategy is concerned with designing optimised audit approaches that seeks to achieve the necessary audit assurance at the lowest cost within the constraints of the information available. The formulation of audit strategy as shall be evident from the process as explained in the following paragraphs in fact shall form the basis of audit planning to achieve the audit objectives in the most efficient and effective manner. Audit strategy generally involves the following steps:

- (i) **Obtaining Knowledge of Business:** SA 315 and SA 330 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" and "The Auditor's Responses to Assessed Risks" states that in performing an audit of financial statements, the auditor should have or obtain knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgement, may have a significant effect on the financial statements or on the examination or audit report. Knowledge of the business is a frame of reference within which the auditor exercises professional judgement. Understanding the business and using this information appropriately assists the auditor in assessing risks and identifying problems, planning and performing the audit effectively and efficiently. It also ensures that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to enable them to carry out the audit work delegated to them. This would also ensure that the audit staff understands the need to be alert for additional information and the need to share that information with the auditor and the other audit staff.
- (ii) **Performing Analytical Procedures:** The purpose of analytical procedures at the planning stage is attention-directing; corroboration is not normally necessary at this stage. The use of the analytical procedures during the planning stage requires the extensive use of accounting and business knowledge and experience to assess the potential for material misstatement in the financial statements as a whole, because the key aspect of the task is to identify the relevant risk indicators and to interpret them properly. Furthermore, analytical techniques applied during the planning stage are not generally as precise as the analytical techniques at the substantive stage.
- (iii) **Evaluating Inherent Risk:** To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors such as quality of accounting system, unusual pressure on management, etc. having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which, might have taken place since his last assessment.
- (iv) **Evaluating Internal Control:** The auditor's assessment of the control environment is crucial to the decision on whether to make an extended assessment of controls. This is because a good control environment is conducive to the maintenance of a reliable system of accounting and control procedures. For strategy purposes, the auditor should obtain a sufficient understanding of the control environment. The auditor needs an understanding of the accounting systems, regardless of whether the audit strategy will involve an extended assessment of internal accounting controls. This is done by:
 - (1) considering the results of gathering or updating information about the client; and

- (2) making preliminary judgements about materiality, inherent risk and control effectiveness. These will include identification of the system(s) the auditor proposes to subject to an extended assessment of controls.

Thus, the audit strategy is evolved after considering the engagement objectives, the results of the business review, preliminary judgements as to materiality and identified inherent risks. Audit strategy also considers main points relating to planning and controlling the audit or comments on adequacy of the existing arrangements. Thus, the overall audit plan involving determination of timing, manpower, coordination and the directions in which the audit work has to proceed is dependent upon the audit strategy formulated by the audit firm.

- (b) As per “SA 520 (Revised) Analytical Procedure”, when the auditor intends to perform analytical procedures on data prepared by the client, he should consider the following:
 - (i) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;
 - (ii) Evaluate the reliability of data from which the auditor’s expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;
 - (iii) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and
 - (iv) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation and if analytical procedures performed in accordance with this SA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:
 - (1) Inquiring of management and obtaining appropriate audit evidence relevant to management’s responses; and
 - (2) Performing other audit procedures as necessary in the circumstances.
4. (a) Basic Accounting Control Objectives which are sought to be achieved by any accounting control system are:
- (i) Whether all transactions are recorded;
 - (ii) Whether recorded transactions are real;
 - (iii) Whether all recorded transactions are properly valued;

- (iv) Whether all transactions are recorded timely;
 - (v) Whether all transactions are properly posted;
 - (vi) Whether all transactions are properly classified and disclosed;
 - (vii) Whether all transactions are properly summarized.
- (b) The following factors will be considered for determination of audit risk at financial statement level.
- (i) Integrity of management.
 - (ii) Management experience, knowledge and changes during the period.
 - (iii) Unusual pressures on the management.
 - (iv) Nature of entity's business.
 - (v) Factors affecting the Industry in which the entity operates.
5. (a) In determining whether to use CAATs, the auditor should consider the following factors:
- (i) **Availability of sufficient IT knowledge and expertise:** It is essential that members of the audit team should possess sufficient knowledge and experience to plan, execute and use the results of CAATs. The audit team should have sufficient knowledge to plan, execute and use the results of the particular CAAT adopted.
 - (ii) **Availability of CAATs and suitable computer facilities and data in suitable format:** The auditor may plan to use other computer facilities when the use of CAATs on an entity's computer is uneconomical or impractical, for example, because of an incompatibility between the auditor's package programme and entity's computer.
 - (iii) **Impracticability of manual tests due to lack of evidence:** Some audit procedures may not be possible to perform manually because they rely on complex processing (for example, advanced statistical analysis) or involve, amounts of data that would overwhelm any manual procedure.
 - (iv) **Impact on effectiveness and efficiency in extracting data:** It includes selection of samples, applying analytical procedures, time involved in application of CAATs, etc.
 - (v) Time constraints in certain data, such as transaction details, are often kept for a short time and may not be available in machine-readable form by the time auditor wants them. Thus, the auditor will need to make arrangements for the retention of data required, or may need to alter the timing of the work that requires such data.
- (b) In evaluating the effects of a control, the auditor needs to assess the reliability by considering the various attributes of a control. Some of the attributes for example are that the control is in place and is functioning as desired, generality versus

specificity of the control with respect to the various types of errors and irregularities that might occur, general control inhibit the effect of a wide variety of errors and irregularities as they are more robust to change controls in the application sub-system which tend to be specific control because component in these sub-system execute activities having less variety, that whether the control acts to prevent, detect or correct errors etc.

The auditor focuses here on

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

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

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

- (1) Ensure that authorized, correct and complete data is made available for processing;
 - (2) Provide for timely detection and correction of errors.
 - (3) Ensure that the case of interruption in the work of the CIS environment due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records;
 - (4) Ensure the accuracy and completeness of output;
 - (5) Provide adequate data security against fire and other calamities, wrong processing, frauds etc.,
 - (6) Prevent unauthorized amendments to the program;
 - (7) Provide for safe custody of source code of application software and data files.
6. (a) 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 ₹ 50 lakhs for inventory obsolescence in 2010-11. 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 ₹ 25 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.

- (b) 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.

- (c) 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.

- (d) According to AS 12, "Accounting for Government Grants" where grant is received for the acquisition of a specific fixed asset, the same cannot be credited to Profit and Loss Account since it fails to match revenue with the cost.

As per AS 12, such grants should be presented in the balance sheet showing the grant as a deduction from the gross value of the asset concerned (in arriving at its book value). Alternately, the grants related to a depreciable fixed asset may be treated as deferred income which should be recognised in the profit and loss account on a systematic and rational basis over the useful life of the asset. By crediting the entire amount of grant to profit and loss account, the company has treated it as a revenue income which is not in accordance with the requirements of the accounting standard.

Therefore, the statutory auditor would have to qualify appropriately that the income has been overstated to the extent of the amount of grant net of proportionate credit that would have been worked out.

- 7 (a) (i) 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), the securities premium account may be applied by the company—

- (i) in paying up unissued shares of the company to be issued to members of the company as fully paid bonus securities;
- (ii) in writing off the preliminary expenses of the company;
- (iii) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; or

- (iv) 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 but can adjust preliminary expenses of ₹ 25 lacs.

- (ii) 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 ₹ 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 ₹ 1000. Therefore, the contention of Mr. Varun that he does not incur disqualification is not correct as he has purchased a ticket of the value of ₹ 20,000. The provisions concerning disqualifications of auditor as contained in Sec 226 (3) (d) will be attracted.
 - (iii) 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 made sufficient profits in last four years and contributed ₹ 2.5 lacs during the year to a political party for running a school. This is in accordance with the provisions of Section 293-A of the Companies Act and also the children of its workers are benefited.
- (b) (i) 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 reporting on personal expenses" has been dispensed with in CARO, 2003.
- (ii) 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.

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.
8. (i) Under Section 62 of the Companies Act, 1956, directors of a company and persons connected with the issue of the prospectus as experts (whose reports form part of the prospectus) are liable to pay compensation to aggrieved persons for any misstatement in the prospectus. A professional accountant makes certain reports in the prospectus of a company under the Companies Act, 1956 as an expert. Accordingly, if the misstatement could be attributed to the auditors' report in the prospectus, he would be liable to compensation to the persons who have financially suffered due to their having acted on the basis of the auditor's report in the prospectus. The civil liability under the Companies Act, 1956 is in addition to the

liability under the general law enforceable by suit for recovery of damages on the ground of fraud, etc. The measure of damages under this section is the loss suffered by reason of the untrue statement. Under section 628, an auditor is liable for criminal prosecution, if he, in any return, certificate, balance sheet, prospectus, statement or other document required by or for the purpose of the Act, makes a statement (a) which is false in any material particular knowing it to be false; or (b) which omits any material fact knowing it to be material. If convicted, he can be punished with imprisonment for a term exceeding to two years and also with fine.

- (ii) In the given case, certain weaknesses in the internal control procedure in the payment of wages in a large construction company were noticed by the statutory auditor and brought the same to the knowledge of the Managing Director of the company. In the subsequent year, a huge defalcation took place, the ramification of which stretched to the earlier year. The management of the company desires to sue the statutory auditor for negligence. The precise nature of auditor's liability in the case can be ascertained on the basis of the under noted considerations:

- (i) Whether the defalcation emanated from the weaknesses noticed by the statutory auditor, the information regarding which was passed on to the management; and
- (ii) Whether the statutory auditor properly and adequately extended the audit programme of the previous year having regard to the weaknesses noticed.

SA 265 on "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management" clearly mentions that, "The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis". The fact, however, remains that, weaknesses in the design of the internal control system and non-compliance with identified control procedures increase the risk of fraud or error. If circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate. Thus, normally speaking, as long as the auditor took due care in performing the audit work, he cannot be held liable.

9. (a) As per the Statement on CARO, 2003 issued by ICAI, for determining the applicability of the CARO, 2003 to a private limited company, both capital as well as the revenue reserves shall be taken into consideration while computing the limit of rupees fifty lacs prescribed for paid up capital and reserves. Revaluation reserve, if

any, should also be taken into consideration while determining the figure of reserves for the limited purpose of determining the applicability of the Order. The credit balance in the profit and loss account should also be considered as a part of reserve since the balance in the profit and loss account is available for general purposes like declaration of dividend. The debit balance in the profit and loss account, if any, should be reduced from the figure of revenue reserves only. If the company does not have revenue reserves, debit balance of profit and loss account cannot be reduced from the figures of paid up capital, capital reserve and revaluation reserve.

Accordingly the profit and loss account (Dr Balance) of ₹6 lacs can be deducted from revenue reserve and hence CARO, 2003 would not be applicable to the Company.

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

Hence, in the instant case Tata Private Ltd. has granted loan of ₹35 crores to Docomo Ltd., a sister concern needs to be reported as per Paragraph 4 (iii) (a) and 4 (v) (a) of CARO, 2003

10. The Companies Act, 1956 does not require a company to necessarily have an internal audit system. As per Para 4(vii) of CARO, 2003, statutory auditor is required to comment on whether the auditee company has an internal audit system commensurate with its size and nature of its business.

The clause has a mandatory application in respect of listed companies irrespective of the size of paid-up capital and reserves or turnover. For other companies, it is applicable if either of the following conditions is satisfied:

- (a) The company has a paid-up capital and reserves exceeding ₹ 50 lakhs at the commencement of the financial year, or
- (b) The company has an average annual turnover of ₹ 5 crores or more for a period of 3 consecutive financial years immediately preceding the financial year concerned.

In the instant case, PQR Ltd is a listed company and having an average annual turnover of more than ₹ 5 crores. Hence, the auditor will have to mention in his report the fact of not having such internal audit system by the Company.

11. (a) The following points require special attention in the examination of Inter Branch transactions.

- (i) While verifying the closing balance, special attention should be paid to the origin and validity of old outstanding unmatched entries, particularly debit entries. The auditor may also seek confirmation of transactions relating to outstanding in appropriate cases.
 - (ii) Whether there are any reversal entries indicating the possibility of irregular payments or frauds.
 - (iii) Whether the balances include any items in the nature of cash in transit included in this head which remain pending for more than a reasonable period. This is because such items are not expected to remain outstanding beyond a very small period during which they are in transit.
 - (iv) Whether transactions other than those relating to inter branch transactions have been included in inter branch accounts. Any unusual items put through inter branch accounts as well as old or large entries outstanding in Inter branch accounts should be carefully looked into. The auditor should also seek explanations from the Management in this regard in appropriate cases.
- (b)** If any advance, including bills purchased and discounted, becomes Non-Performing Assets as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s).

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

Thus, he should examine:

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

The auditor can gather the requisite evidence by examining relevant documents

(such as loan application forms, supporting documentation, sanctions, security documents, etc.) and by obtaining information and explanations from the branch management in appropriate cases.

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

12. (a) Steps in Audit of Reinsurance ceded

- (i) Evaluate internal control system in the area of reinsurance ceded to ensure determination of correct amount for reinsurance ceded, proper valuation of assets and liabilities arising out of reinsurance transaction and adherence to legal provisions and regulations.
- (ii) Ascertain whether adequate guidelines and procedures are established with respect to obtaining reinsurance.
- (iii) Reconcile reinsurance underwriting returns received from various units with the figures of premium, claims paid and outstanding claims for the company as a whole.
- (iv) Examine whether commission on reinsurance ceded is as per the terms of the agreement with the re-insurers.
- (v) Examine the computation of profit / commission for automatic treaty arrangements in the light of the periodic accounts rendered and in relation to outstanding loss pertaining to the treaty.
- (vi) Examine whether loss recoveries have been claimed and accounted on a regular basis.
- (vii) Examine whether outstanding losses recoverable have been confirmed by re-insurers.
- (viii) Examine whether remittances to foreign re-insurers are as per foreign exchange regulations.
- (ix) Examine whether confirmations have been obtained regarding balances with re-insurers.
- (x) Review individual accounts of re-insurers to evaluate whether any provision/write off or write back is required

(b) Directions under Section 619 (3) (a) of the Companies Act, 1956, applicable to Insurance Companies in respect of System of Accounts

- (i) Examine the following systems and give your views as regards their deficiencies alongwith suggestions for remedial measures:-
 - (a) Recording of receipts and expenditure.
 - (b) Drawing periodical trial balance.

- (c) Compilation of accounts.
 - (d) Reconciliation of inter-office accounts.
 - (e) Reconciliation of registers/records relating to property, assets. Investments, premiums, claims, loans, etc., with financial books.
 - (f) Maintenance of up-to-date records in respect of assets, which are pledged, encumbered or blocked in any way.
- (ii) Are the bank accounts of the company reconciled with the bank statements regularly? If not, describe the failures.
 - (iii) Are control accounts and subsidiary accounts up-to-date and reconciled regularly? If not, describe the failures.
 - (iv) Examine the accounting policies of the company. Are these in conformity with the Accounting Standards. Give particulars of material departures from these standards, if any, alongwith their effect on the financial statements; quantify the impact wherever possible.
- 13. (a)** Following are the special features in the audit of a cooperative society:
- Examination of overdue debts.
 - Special treatment of over due interest in the determination of profit.
 - Certification of bad debts before write off.
 - Valuation of assets and liabilities
 - Adherence to co-operative Principles.
 - Observations of the Provisions of the Act and Rules
 - Verification of members' Register and examination of their pass books
 - Special report to the registrar on fraud, mismanagement and personal profiteering.
 - Audit classification of society based on the audit findings
 - Discussion of draft audit report with the managing committee.
- (b)** Section 17 of the Co-operative Societies Act, 1912 specifically requires the auditor to conduct an examination of the overdue debts, if any, and a valuation of the assets and liabilities of the society. Apart from this, the form in which the auditor has to submit his audit report reveals the nature of his duties. The auditor of a co-operative society is also required to point out various irregularities, improprieties, and departures from the provisions of the Act, rules framed thereunder, and the bye-laws of the society. The form of the audit report to be submitted by the auditor, as prescribed in various states, contains a number of matters which the auditor has to state or comment upon. For example, the Rules formed under the Maharashtra State Co-operative Societies Act requires the auditor to make the usual affirmation pertaining to proper maintenance of books of accounts, true and fair nature of

financial statements, etc .In addition to the above, the auditor will have to attach schedules to the report regarding the following information:

- (i) All transactions which appear to be contrary to the provisions of the Act, the rules and bye-laws of the society.
- (ii) All sums, which ought to have been, but have not been brought into account by the society.
- (iii) Any material, or property belonging to society which appears to the auditor to be bad or doubtful of recovery.
- (iv) Any material irregularity or impropriety in expenditure or in the realisation or monies due to society.
- (v) Any other matters specified by the Registrar in this behalf.

In the case of nil report in any of the above matters, the auditor will have to give a nil report.

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

- (i) Ascertain whether the NBFC has an adequate appraisal system for extending hire purchase finance. The system of appraisal is basically concerned with obtaining information regarding the credit worthiness of the hirer, his experience in the field, assets owned, his past track record and future projections of his income.
- (ii) Verify that the payment for acquiring an asset should be made directly to the supplier/dealer and that the original invoice has been drawn out in the name of the NBFC.
- (iii) In the case of high value hire purchase items relating to machinery/equipment, an auditor should ascertain whether the valuation reports and installation reports are called for. In case of some high value items, he should also physically verify the asset in possession of the hirers, particularly in a situation where he has any doubts as regards the genuineness of the transaction.
- (iv) If the hire purchase finance is against vehicles, check whether the registration certificate contains an endorsement in favour of the hire purchase company.
- (v) The auditor should verify whether the NBFC has a system in place for verifying the hire purchase assets periodically to ensure that the hirers have not sold the assets or otherwise encumbered them.
- (vi) Check whether hire purchase instalments are being received regularly as and when they fall due. Check whether adequate provision has been made for overdue hire purchase instalments as required by the NBFC Prudential Norms directions.
- (vii) Examine the method of accounting followed by the hire purchase finance

company for appropriation of finance charges over the period of the hire purchase contract. Ascertain that there is no change in the method of accounting as compared to the immediately preceding previous year.

- (viii) Verify that the assets given on hire purchase have been adequately insured against.
- (ix) In case the goods are repossessed by the hire purchase finance company on account of non-repayment of hire purchase instalments, verify that the repossessed goods have been valued on a realistic basis by the hire purchase finance company.

(b) Compliance of Prudential Norms by NBFC

- (i) The auditor has to verify the compliance of prudential norms relating to (1) income recognition; (2) Income from investments; (3) Asset classification; (4) Provision for bad and doubtful debts; (5) Capital adequacy norm; (6) Prohibition of granting loans against its own shares; (7) Prohibition on loans and investments for failure to repay public deposits and (8) Norms for concentration of credit etc.
- (ii) The auditor shall ensure that Board of the NBFC shall frame a policy for granting demand/call loans and implement the same.
- (iii) The auditor should verify the classification of advances and loans as standard/substandard/doubtfull/loss and that proper provision has been made in accordance with the directions.
- (iv) Auditor should ensure that unrealised income from non-performing assets has not been taken to profit and Loss Account.
- (v) The auditor should check all NPAs of the previous years to verify whether during the current year any payments have been received or still they continue to be NPA during the current year also.

15. (a) Clause 13(c) of Form 3 CD: A tax auditor has to report under clause 13(c) of Form 3 CD on any escalation claim accepted during the previous year and not credited to the profit and loss account under clause 13(c) of Form 3 CD.

The escalation claim accepted during the year would normally mean “accepted during the relevant previous year.” If such amount is not credited to Profit and Loss Account the fact should be reported. The system of accounting followed in respect of this particular item may also be brought out in appropriate cases. If the assessee is following cash basis of accounting with reference to this item, it should be clearly brought out since acceptance of claims during the relevant previous year without actual receipt has no significance in cases where cash method of accounting is followed.

Escalation claims should normally arise pursuant to a contract (including contracts entered into in earlier years), if so permitted by the contract. Only those claims to which the other party has signified unconditional acceptance could constitute

accepted claims. Mere making claims by the assessee or claims under negotiations cannot constitute accepted claims. After ascertaining the relevant factors as outlined above, a decision whether to report or not, can be taken.

- (b) Normally, the report of the tax auditor cannot be revised later. However, when the accounts are revised in the following circumstances, the tax Auditor may have to revise his Tax audit report also.
- (i) Revision of accounts of a company after its adoption in the annual general meeting.
 - (ii) Change in law with retrospective effect.
 - (iii) Change in interpretation of law (e.g.) CBDT Circular, Notifications, Judgments, etc.

The Tax Auditor should state it is a revised Report, clearly specifying the reasons for such revision with a reference to the earlier report.

- (c) Income under the head Profit & Gains of business or profession or income from other sources has to be computed under mercantile or cash system of accounting as regularly maintained by the assessee.

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

- (i) AS (IT)-1: Disclosure of accounting policies.
- (ii) AS (IT)-2: Disclosure of prior period and extra ordinary items and disclosure of accounting policies.

The above AS are corresponding to AS-1 and AS-5 issued by the ICAI as per 145(3) the Assessing Officer may make a best judgement assessment under section 144 in the following situation:

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

The auditor has to therefore ensure that:

- (a) the entity follows either the cash or accrual method of accounting and same is to be reported in 11(a) of form 3CD.
- (b) Accounting policies are required by AS (IT) -1 has been disclosed needs to be verified for compliance with ASI (11) of AS5 (11).

(c) Other provisions of AS 1 (IT) and AS (IT) -2 have been complied with.

16. (a) A cost auditor checks the cost accounting records to verify that the cost statements are properly drawn up as per the records and that they present a true and fair view of the cost of production and marketing of various products dealt with by the undertaking. The Cost Audit (Report) Rules, 1996 as amended in 2001, prescribe the rules regarding the cost audit report. The prescribed format of the report contains assertions regarding whether cost accounting records have been properly kept so as to give a true and fair view of the cost of production/ processing/ manufacturing/ mining activities and marketing of the product under reference. It may be noted that unlike in the case of audit of financial statements, the cost auditor does not have to state whether the cost statements reflect a true and fair view. In any case, the true and fair concept is known to us in the context of financial accounts. Based on that knowledge, it may be assumed that the following are the relevant considerations in determining whether the cost of production determined is true and fair:

- (i) Determination of cost following the generally accepted cost accounting principles.
- (ii) Application of the costing system appropriate to the product.
- (iii) Materiality.
- (iv) Consistency in the application of costing system and cost accounting principles.
- (v) Maintenance of cost records and preparation of cost statements in the prescribed form and having the prescribed contents.
- (vi) Elimination of material prior-period adjustments.
- (vii) Abnormal wastes and losses and other unusual transactions being ignored in determination of cost.

- (b) **Matters to be included in Cost Audit Programme:** It is a true statement that like any other audit a systematic planning for cost audit is also necessary. Therefore, the cost audit programme should include all the usual broad steps that a financial auditor includes in his audit programme. This would require that the various aspects like what to be done, when to be done and by whom to be done are adequately taken care of. However, looking to the basic difference in cost audit and financial audit as allocation and apportionment of expenses, statutory requirement etc. should require special consideration. Cost audit, in order to be effective, should be completed at one time as far as practicable. Based on above factors a set of procedures and instructions are evolved which may be termed the cost audit programme. Matters to be included in the Cost Audit Programme may be divided into following two stages:

- (i) Review of Cost accounting record: This will include:
 - (1) Method of costing in use - batch, process or unit.

- (2) Method of accounting for raw materials; stores and spares, wastages, spoilage defectives, etc.
- (3) System of recording wages, salaries, overtime and spares, wastages, etc.
- (4) Basis of allocation of overheads to cost centres and of absorption by products and apportionment of service department's expenses.
- (5) Treatment of interest, recording of royalties, research and development expenses, etc.
- (6) Method of accounting of depreciation.
- (7) Method of stock-taking and its valuation including inventory policies.
- (8) System of budgetary control.
- (9) System of internal auditing.
- (ii) Verification of cost statement and other data: This will mainly cover:
 - (1) Licensed, installed and utilised capacities.
 - (2) Financial ratios.
 - (3) Production data.
 - (4) Cost of raw material consumed, wages and salaries, stores, power and fuel, overheads provision for depreciation etc.
 - (5) Sales realisation.
 - (6) Abnormal non-recurring and special costs.
 - (7) Cost statements.
 - (8) Reconciliation with financial books.

Some other factors which need to be brought into cost audit programme includes system of cost accounting, range of products, areas to be covered etc. indicating allocation of manpower and the time to be taken for computing the audit.

- 17. (a)** The external auditor's general evaluation of the internal audit function will assist him in determining the extent to which he can place reliance upon the work of the internal auditor. The external auditor should document his evaluation and conclusions in this respect. The important aspects to be considered in this context are:
- (i) **Organisational Status** - Whether internal audit is undertaken by an outside agency or by an internal audit department within the entity itself, the internal auditor reports to the management. In an ideal situation he reports to the highest level of management and is free of any other operating responsibility. Any constraints or restrictions placed upon his work by management should be carefully evaluated. In particular, the internal auditor should be free to communicate fully with the external auditor.

- (ii) **Scope of Function** - The external auditor should ascertain the nature and depth of coverage of the assignment which the internal auditor discharges for management. He should also ascertain to what extent the management considers, and where appropriate, acts upon internal audit recommendations.
 - (iii) **Technical Competence** - The external auditor should ascertain that internal audit work is performed by persons having adequate technical training and proficiency. This may be accomplished by reviewing the experience and professional qualifications of the persons undertaking the internal audit work.
 - (iv) **Due Professional Care** - The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. An example of the exercise of due professional care by the internal auditor is the existence of adequate audit manuals, audit programmes and working papers.
- (b) While conducting the operational audit the auditor has to come across many irregularities and areas where improvement can be made and therefore he gives his suggestions and recommendations.

These suggestions and recommendations for improvements may not be accepted by the hostile managers and in effect there may be cold war between the operational auditor and the managers. This would defeat the very purpose of the operational audit.

The Participative Approach comes to the help of the auditor. In this approach the auditor discusses the ideas for improvements with those managers that have to implement them and make them feel that they have participated in the recommendations made for improvements. By soliciting the views of the operating personnel, the operational audit becomes co-operative enterprise.

This participative approach encourages the auditee to develop a friendly attitude towards the auditors and look forward to their guidance in a more receptive fashion. When participative method is adopted then the resistance to change becomes minimal, feelings of hostility disappear and gives room for feelings of mutual trust. Team spirit is developed. The auditors and the auditee together try to achieve the common goal. The proposed recommendations are discussed with the auditee and modifications as may be agreed upon are incorporated in the operational audit report. With this attitude of the auditor it becomes absolutely easy to implement the proposed suggestions as the auditee themselves take initiative for implementing and the auditor do not have to force any change on the auditee.

Hence, Operational Auditor of DLF manufacturing unit should adopt above mentioned participative approach to tackle the hostile management of DLF.

18. As per the facts that there has been consistently high turnover but declining net profits is an anomalous situation. It may be attributed to one or more following reasons requiring further investigation:
- (i) **Unfavourable Sales mix:** Where the company sells different chemical products with different product margins, the product with the maximum PV ratio/margin should have a higher share in the total sales. If due to revision of sales mix, more quantities of unprofitable products are sold, profits will be reduced in spite of an increase in sales.
 - (ii) **Negative Impact of Financial Leverage:** Where the company does not have sufficient own funds (equity) but has a higher debt-equity ratio, the interest commitments will be higher. As the volume of its operation increases, higher debt and interest charges would result in lower profits.
 - (iii) **Other Items Included in Sales:** The figure of sales as per Profit and Loss Account may include incidental revenues, e.g., freight, excise duty, sales-tax, etc. where the amount of excise duty goes up considerably the total sales may show an increase which is not represented by a real increase in sales quantity/value.
 - (iv) **High Administrative and Selling Expenses:** Administrative and selling costs are generally period costs which are fixed in nature. Their increase is generally not proportional to sale increase. However, a reduction in profit could also be due to increase in administrative overheads and sales overheads at a rate higher than the rate of increase in sales.
 - (v) **Cost-Price Relationship:** If the increases in cost of raw materials and labour has not been compensated by a corresponding increase in the sales price this would also result in higher sales and declining profits. In spite of same sales quantity, for the increasing cost of raw materials and other services, per unit values of the product has been increased which is however unmatched by the increase in cost.
 - (vi) **Competitive Price:** Where sales have been made at cut-throat prices in order to eliminate competition from the market, the profits would be in the declining trend in the short-run.
 - (vii) **Additions to Fixed Assets:** Where there are heavy additions to fixed assets and consequent depreciation charges in the initial years of additions, there may be reduction in profits in spite of increased sales.
- 19 (a) Under clause 11 of Part I of First Schedule to the Chartered Accountants Act, a chartered accountant in practice is deemed to be guilty of professional misconduct, if he engages in any business or occupation other than the profession of chartered accountants, unless permitted by the council so to engage.
- However, nothing contained in clause 11 shall disentitle a chartered accountant from being a director of a company, unless he or any of his partners is interested in such company as an auditor.

Regulation 190A, states a member in practice cannot engage himself in any business or occupation other than that of a chartered accountant except when permitted by the council. As per Appendix 10 of Chartered Accountants Regulations, 1988, a Chartered Accountant in practice may hold the office of a Managing Director a Whole-time Director of a body corporate, provided that the member and/or his relatives do not hold substantial interest in such concern, after obtaining the specific and prior approval of the Council.

He should seek prior approval of the council otherwise he would be held guilty of misconduct.

- (b) Under clause 12 of Part I of First Schedule to the Chartered Accountants Act a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he allows a person not being a member of the Institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

This clause read in conjunction with Section 26 of the Chartered Accountants Act, 1949 stipulates that no person other than the member of the institute shall sign any document on behalf of a Chartered Accountant in practice or a firm of Chartered Accountants in his or its professional capacity.

The term 'Financial Statement' for this purpose would cover an examination of the accounts or financial statements given under a statutory enactment or otherwise. Accordingly S is guilty of professional misconduct under clause 12 of part I of First Schedule and also under clause (1) of Part II of Second Schedule for contravening Section 26.

- (c) As per clause 5 of Part I of Second Schedule if a member in practice fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary to make the financial statement not misleading where he is concerned with that financial statement in a professional capacity, he will be held guilty under clause (5). As per clause 6 of Part I of Second Schedule if he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity, he will be held guilty under clause 6.

In given case, the Chartered Accountant had submitted the statements before the taxation authorities. These statements are based on the data provided by the management of the company. Although the statements prepared were based on incorrect facts and misleading, the Chartered Accountant had only submitted them acting on the instructions of his client as his authorized representative.

Hence the Chartered Accountant would not be held liable for professional misconduct.

- (d) Under clause 3 of Part II of second schedule of the Chartered Accountant Act, 1949, a Chartered Accountant whether in practice or not is guilty of professional misconduct if he includes in any information, statement, return or form to be

submitted to the Institute, Council or any of its committees, Directors (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.

In the instant case A B & Co. included another Chartered Accountant name as partner in his firm, in his application for empanelment as Auditor of branches of Public Sector Banks submitted to the Institute. In fact such a member was not a partner of the said firm on the date of application. He will be held guilty of professional misconduct.

20. (a) Constitution and Functions of Audit Committee: Section 292A of the Companies Act, 1956 requires that every public company having not less than ₹ 5 crores of paid up capital shall constitute a committee of Board known as Audit Committee. It shall consist of not less than three directors and such number of other Directors as the Board may determine of which two-third shall be directors other than the Managing Director and whole time director. They shall elect one such member amongst them as Chairman. 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.

Every audit committee constituted as above shall act in accordance with the terms of reference specified in writing by a Board. The function of the audit committee as specified in the Companies Act, 1956 are as under:

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

authorise another person to sign the contract notes, then the member is required to submit a power of attorney to the Exchange. In case of corporate membership, a board resolution is required to authorise a person including Directors to sign the contract notes.

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

- (i) Contract notes have been serially numbered.
- (ii) No serial number has been left blank.
- (iii) Format of the Contract Note is as prescribed by the Regulations of the Exchange.
- (iv) Duplicate copies / counterfoils of contract notes are maintained.
- (v) Brokerage charged in contract notes is within the permissible limits and is indicated separately including service tax.
- (vi) Contract notes have been signed by an authorised person.
- (vii) Contract notes have been issued in respect of all transactions.
- (viii) Transaction Identification, Trade Identification and Trade Execution time has been printed on the contract note issued.
- (ix) SEBI Registration number, Settlement number, Settlement dates have been mentioned.
- (x) PAN number of the member and client has been mentioned on Contract Note where if required.
- (xi) All clauses specified by the Exchange have been printed on the reverse of the contract notes.

(c) Areas of propriety audit under Section 227(1A)

Section 227(1A) of the Companies Act, 1956 requires the auditor to make an enquiry into certain specific areas. In some of the areas, the auditor has to examine the same from propriety angle as to:

- (i) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members;
- (ii) Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company;

- (iii) Whether the company is not an investment of company within the meaning of section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
 - (iv) Whether loans and advances made by the company have been shown as deposits. Again, considering the propriety element, rationalizing the proper disclosure of loans and advance given by company is made;
 - (v) Whether personal expenses have been charged to revenue account;
 - (vi) In case it is stated in the books and papers of the company that shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash actually received, whether the position in books of account and balance sheet so stated is correct, regular and not misleading. A control has been set up to verify the receipt of cash in case of allotment of shares for cash. Further, if cash is not received, the books of accounts and statement of affairs show the true picture.
- (d) **Collection of Evidence by Peer Reviewer:** A Peer Reviewer collects evidence by applying the following methods:
- (i) Inspection mainly consists of examination of documentation (working papers) and other records maintained by the practice unit.
 - (ii) Observation consists of witnessing a procedure or process being performed by others. For example, while conducting on-site review, the reviewer may review the performance of internal control.
 - (iii) Inquiry consists of seeking appropriate information from the partner (designated by the practice unit for the purpose)/sole proprietor or other knowledgeable persons within the practice unit. The inquiries may originate from the responses to the questions given in the questionnaire. The inquiries may also arise from the inspection of documentation maintained by the practice unit.

While observation and inquiry may be considered as external independent sources of review evidence, inspection remains the most significant method for confirming the effective observance of control procedures in the practice unit. Observation and inquiry may also corroborate the evidence provided by inspection. The reviewer, in order to carry out the review effectively, should have an understanding of the documentation maintained by the practice unit