

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

SUGGESTED ANSWERS/HINTS

1. (a) This case requires attention to SA 560 "Subsequent Events", AS 4 "Contingencies and Events occurring after the Balance Sheet Date" and AS 29 "Provisions, Contingent liabilities and Contingent Assets".

As per AS 4 "Contingencies and Events occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. Similarly as per AS 29 "Provisions, Contingent liabilities and Contingent Assets", future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that the will occur.

In the instant case, the amount of ₹ 1.50 crores is a material amount and it is the result of an event, which has occurred after the Balance Sheet date. The facts have become known to the auditor before the date of issue of the Audit Report and Financial Statements.

The auditor has to perform the procedure to obtain sufficient, appropriate evidence covering the period from the date of the financial statements i.e. 31-3-2010 to the date of Auditors Report ie.31-05-2010. It will be observed that as a result of long pending negotiations a sum of ₹ 1.50 cores representing arrears of salaries of the year 2008-09 and 2009-10 have not been included in the financial statements. It is quite clear that the obligation requires provision for outstanding expenses as per AS 4 and AS 29.

As per SA 560 "Subsequent Events", the auditor should assure that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

So the auditor should request the management to adjust the sum of ₹1.50 crores by making provision for expenses. If the management does not accept the request the auditor should qualify the audit report.

- (b) The contention of the CEO of B Co. Ltd. is correct. AS 7 "Construction Contract", should be applied in accounting for construction contracts in the financial statements of contractors.

The activity of the B Co. Ltd. is not that of a contractor. The company is developing projects on its own account as a commercial venture and is in the nature of production activity and not that of a contractor. Therefore AS 7 will not be applicable to B Co. Ltd.

For the purpose of recognition of Revenue and valuation of inventories B Co. Ltd. should follow the principles contained in AS 9 "Revenue recognition" and AS 2 "Valuation of Inventories".

- (c) As per AS 10 "Accounting for Fixed Assets", the cost of an item of fixed asset comprise its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use.

Generally, detention charges represent an abnormal expenditure, as these expenditures are not directly attributable to the cost of asset.

The auditor will qualify the report appropriately in the paragraph before stating that the balance sheet gives true and fair view and the profit and loss account shows true and fair profit of the year ending on 31-3-2010. The qualification will be as follows:

"Attention is invited to Note no. 11 regarding Capitalization of detention charges of ₹ 364 lakhs during the year and on account of delays in respect of clearing from custom warehouses for certain machinery items". In our opinion the detention charge are not directly attributable to the acquisition of related fixed assets. The said amount of ₹ 364 lakhs should have been written off in the Profit and Loss account. Had these expenses been so written off the profit for the year would have been lower by ₹ 364 lakhs and Reserves & Surplus as well as Fixed Assets/Capital WIP would have been lower by ₹ 364 lakhs."

- (d) As per AS 4 "Contingencies and Events occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date.

In the instant case, it appears from the note no 15 that the overdue of outstanding inter corporate deposit may not be realisable in full. The company is in the process of liquidation, makes it clear that on the balance sheet date, the amount of deposit is not safe and is not likely to be realised.

Therefore as per AS 4 provision for the loss is required in the accounts. Hence the auditor should qualify the Audit Report.

2. (a) **Undertaking Tax Representation Work:** In the instant case, a chartered accountant not holding certificate of practice cannot take up any other work because it would amount to violation of the relevant provisions of the Chartered

Accountants Act, 1949. In case a member is suspended and is not holding Certificate of Practice, he cannot in any other capacity take up any practice separable from his capacity to practise as a member of the Institute. This is because once a member becomes a member of the Institute, he is bound by the provisions of the Chartered Accountants Act, 1949 and its Regulations. If he appears before the income tax authorities, he is only doing so in his capacity as a chartered accountant and a member of the Institute. Having bound himself by the said Act and its Regulations made thereunder, he cannot then set the Regulations at naught by contending that even though he continues to be a member and has been punished by suspension, he would be entitled to practice in some other capacity. Thus in the instant case, a chartered accountant would not be allowed to represent before the income tax authorities for the period he remains suspended.

- (b) **Embezzlement of Funds:** As per clause 2 of Part-IV of First Schedule of the Chartered Accountant Act, 1949, "If a member of the Institute whether in practice or not shall be deemed guilty of other misconduct if he in the opinion of the Council brings disrepute to the profession or the Institute as a result of his action whether or not related to professional work".

Further, Section 21 of the Chartered Accountants Act, 1949 provides that a member is liable for disciplinary action if he is guilty of any professional or "Other Misconduct." Though the term "Other Misconduct" has not been defined in the said Act, this provision enables the Council to enquire into any misconduct of a member even if it does not arise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards even in his non-professional work, would expose him to disciplinary action. The Council has also laid down that among other things "misappropriation by an office-bearer of a Regional Council of the Institute of a large amount and utilization thereof for his personal use" would amount to "other misconduct".

Thus, in the instant case, Mr. R would be liable for disciplinary action.

- (c) **Sale of Goodwill:** The Council of the Instituted considered the issue whether the goodwill of a proprietary firm of chartered accountant can be sold/transferred to another eligible member of the Institute, after the death of the proprietor concerned and came to the view that the same is permissible. The Council resolved that the sale/transfer of goodwill in the case of a proprietary firm of chartered accountant to another eligible member of the Institute shall be permitted. It further laid down that in cases where the death of proprietor occurs after 30/8/1998, the goodwill of the deceased member's practice can be sold to another member and permission of the Institute has to be obtained within a year of the death of the proprietor concerned. It is even laid down that in such cases the name of the proprietary firm concerned would not be removed upto a period of one year from the death of the proprietor. Thus, in the instant case, when the widow of Mr. Q sells the practice to another

member, it is nothing but goodwill sold to another member. The sale of the practice and the right to use the name is also allowed in terms of the above decision of the Council. Thus the above act of the widow of Mr. Q is permissible.

- (d) **Posting of Particulars on Website:** The Council of the Institute had approved posting of particulars on website by Chartered Accountants in practice under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949 subject to the prescribed guidelines. The relevant guidelines in the context of the website hosted by M/s XYZ are:

- ◆ No restriction on the colours used in the website;
- ◆ The websites are run on a “pull” technology and not a “push” technology
- ◆ Names of clients and fees charged not to be given.

In view of the above, M/s XYZ would have no restriction on the colours used in the website but failed to satisfy the other two guidelines. Thus, the firm would be liable for professional misconduct since it would amount to soliciting work by advertisement.

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

- (I) As per Paragraph 4(ix)(b) CARO, 2003 “In case dues of Income Tax/ Sales Tax/ Service Tax/ Customs Duty/ Wealth Tax/ Excise Duty/ Cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. However, a mere representation to the Department shall not constitute the dispute.”

The auditor should also obtain a management representation about the disputed dues, the amounts involved and the forum where the dispute is pending. The auditor should carry out necessary audit procedures to verify the information provided by the management.

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

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

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

With reference to the regularity, in case of custom duty on import of goods or demands arising on account of assessment orders etc., which a company is required to pay as and when an event giving rise to the liability of the company occurs. Such dues should be construed to have been paid regularly if the company deposits them as and when they become due. However, the auditor would be required to comment upon the regularity of the company in depositing the installments, if any, granted by an authority in respect of a demand against the company.

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

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

- (i) Quantify energy costs and quantities
- (ii) Correlate trends of production or activity to energy costs
- (iii) Devise energy database formats to ensure they depict the correct picture – by product, department, consumer, etc.
- (iv) Advise and check the compliance of the organisation for policy and regulation aspects.
- (v) Highlight areas that need attention for detailed investigations.

- (vi) Conduct preliminary and detailed energy audits which should include the following:
 - (a) Data collection and analysis
 - (b) Measurements, mass and energy balances
 - (c) Reviewing energy procurement practices
 - (d) Identification of energy efficiency projects and techno-economic evaluation
 - (e) Establishing action plan including energy saving targets, staffing requirements, implementation time requirements, procurement issues, details and cost estimates.
 - (f) Recommendations on goal setting for energy saving, record keeping, reporting and energy accounting, organisation requirements, communications and public relations.

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

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

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

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

4. **(a) Precautions before Commencing the Audit Work:** In the instant case the auditor before accepting the appointment as well as commencing the audit work, the auditor should see the following:
 1. When a previous auditor resigned the auditor should verify that the resolution appointing him as the auditor at the general meeting was duly moved and

approved by the shareholders.

2. The auditor should refer to the resignation submitted by the previous auditor.
3. The auditor should communicate with him so as to ascertain.
 - (i) The circumstances which led up to his resignation.
 - (ii) Whether there existed any circumstances on account of which he should not accept the appointment.
 - (iii) Whether the requirements of section 224(6) in respect of such an appointment have been complied with.

Further, Clause (9) of part I of the First Schedule to Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he 'accepts' an appointment as auditor of a company without first ascertaining from it whether the requirements of Sections 224 and 225 of the Companies Act, 1956, in respect of such appointment have been duly complied with.

- (b) **Surprise Checks:** SA 315 & 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" prescribes that "the auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. 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." The understanding of the accounting and internal control system can be obtained in several ways including inspection of documents making inquiries of appropriate management, observation of activities, etc. It is in this context, surprise checks intend to ascertain whether the system of internal control is operating effectively and whether the accounting and other records are prepared concurrently and kept up-to-date. Particularly, the observation of the entity's activities and operations including observation of the organisation of computer operations, personnel performing control procedures and the nature of transaction processing on a surprise visit would reveal the exact manner in which the activities are being performed in the manner prescribed by the management. It has often been found that manipulations and frauds are facilitated under a system of book-keeping, which does not give proper emphasis to the need to keep the books up-to-date. Errors in book-keeping are often indicative of weaknesses in internal control which may be taken advantage of in order to perpetrate frauds or manipulations. Surprise checks are a useful method of determining whether or not such errors exist and where they exist, of bringing the matter promptly to the attention of the management so that corrective action is taken immediately. Consequently, surprise visits by the auditor can exercise a good moral check on the client's staff.

The Guidance Note issued by the Institute on the subject specifies that surprise checks are a part of the normal audit and the results of such checks are therefore important primarily to the auditor himself in deciding the scope of his audit and submitting his report thereon. The need for and frequency of surprise checks is obviously a matter to be decided having regard to the circumstances of each audit. It would depend upon the extent to which the auditor considers the internal control system as adequate, the nature of the clients' transaction, the locations from which he operates and the relative importance of items like cash, investments, stores etc. However, wherever feasible a surprise check should be made at least once in the course of an audit. If this surprise check reveals any weaknesses in the system of internal control or any fraud or error or the fact that any book or register has not been properly maintained or kept up-to-date, the auditor should communicate the same to the management and ensure that action is taken on the matters communicated by him. It does not necessarily follow that all or any of the matters communicated to the management should form part of the auditor's report on the accounts. Thus "surprise checks" help the auditors, during the course of their audit, to ascertain whether the internal control is operating effectively in a company or not.

(c) The review process for controls in a computerized information system (CIS) environment.

In a CIS environment there are different types of control which operate over data moving into, through and out of the computer. These are designed in such a way that the correct, complete and reliable processing and storage is ensured. It is necessary for the auditor to review such controls in order to get the correct result from the data entered. The review process can be laid down as follows:

- (1) **Organisation structure and control:** The entity may have different functions under the CIS environment. There will be Data Administrator who will formulate data policies, plans the evaluation of the corporate data bases and maintain the data documentation... The data base administrator will be responsible for operational efficiency of the database, the system Analyst will manage the information requirements for new and existing applications, and designs the information system, the System programmer will maintain and enhance the Operating system software, application programmer will design the Programme to meet the information requirement, Operation Specialist plans and control day-to-day operations, monitors and improves operational efficiency along with capacity planning and Librarian maintains library of magnetic media and documentation.. The auditor will see that the responsibilities of each job position are clear and that the person understands the duties, authority and responsibilities. The duties have to be separated to ensure the internal control is established.
- (2) **Documentation Control:** The auditor has to see that there is proper and adequate documentation for approval of system flowcharts Programme

flowcharts, Programme changes, operator's instructions and programme description and the changes made in the above are also documented and approved by the authorized persons.

- (3) **Access Control:** The auditor has to ensure the system prevents the persons who are authorized for access from accessing restricted data and programme and also prevents unauthorized persons gaining access to the system as a whole.
- (4) **Input controls:** The control in respect of input has to be effective to ensure that only properly authorized and approved data goes in the input into the CIS system. For validation of input controls the auditor can apply some procedures like Check digit control, completeness totals control, reasonableness checks, field checks, record checks, file checks etc.
- (5) **Processing controls:** These controls are must for integrity of data. Processing validation checks should be applied.
- (6) **Recording Controls:** This is for enabling the records to be kept free of errors.
- (7) **Storage Controls:** The data is the heart of the CIS system. Back up and recovery facilities will ensure the proper data availability to the management.
- (8) **Output controls:** The data processed must go to the authorized person in the manner it is required and for this purpose input controls are maintained. The auditor is interested to know whether the audit trail relating to output is provided.

5. (a) Tax Audit Report

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

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

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

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

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

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

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

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

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

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

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

Thus, he should examine :

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

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

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

(c) Reporting of loan under CARO, 2003

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

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

6. Auditor's report on the Companies Act, 1956 (the Act)

- (i) **Report to Shareholders U/s 227:** Section 227 of the Act lays down powers and duties of the auditor. Sub-sections (2), (3), (4) and (4A) of Section 227 deal with reporting requirements. Sub-section (2) states that the auditor of a company shall make a report to the members on the accounts examined by him and on every balance sheet and profit and loss account which are laid before company in general meeting during the tenure of his office. The significance of the report lies in the fact that it requires that the report shall state whether in his opinion and to the best of his information and according to the explanations given to him the said accounts give the information required by the Act in the manner so required and give a true and fair view.

The functional approach by the auditor for making a report u/s 227 of the Act, requires him to perform compliance and substantive audit procedures to verify the information contained in the financial statements. Having regard to the materiality of the items involved, the auditor also determines whether the relevant information is properly disclosed in the financial statements.

- (ii) **Report to be set out in the prospectus u/s 60(3):** Section 60(3) of the Act provides that a prospectus should be accompanied *inter alia* by the consent in writing of the person named therein as the auditor of the company or intended company, to act in that capacity. Part II of Schedule II to the Act prescribes the reports to be set out in a prospectus. The report contains particulars about profit

and losses of the company for five preceding year, assets and liabilities, rates of dividend, etc. The significance of the report lies in the fact that a prospectus is issued by a company when it seeks to raise funds from the public and gives detailed information about the company to enable prospective investors to take a well-informed decision. The functional approach on the part of auditor involves obtaining information from the management, particularly, in respect of estimation of current and future profits. He has to also ensure that all adjustments have been made properly.

(iii) Special Audit Report U/s 233A: Under section 233A of the Act, the Central Government has a power to order a special audit of the accounts of a company for a specified period. An order to conduct special audit of the accounts of a company may be made where the Central Government is of the opinion that:

- (a) the affairs of the company are not being managed in accordance with sound business principles or prudent commercial practices; or
- (b) the company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or
- (c) the financial position of the company is such as to endanger its solvency.

The main objective of such an audit is to provide a critical review of the company's working and state of affairs to the government. Special audit should be distinguished from 'investigation' into the affairs of a company under section 235 of the Act. The special auditor has the same powers and duties which a company auditor has under section 227 of the Act, with the difference, however, the instead of making his report to the members of the company, the special auditor makes the report to the central government. The special audit report should, as far as possible, include all the information required to be included in an audit report under section 227 of the Act. However, the central government may direct that the special audit report shall also include a statement on any other matter referred to the special auditor by the government.

(iv) Report on the accounts prepared on voluntarily winding up u/s 488 (1): Section 488(1) of the Act requires that where it is proposed to wind up a company voluntarily, its directors, or in case the company has more than two directors, the majority of the directors, may at a meeting of the Board, make a declaration verified by an affidavit, to the effect that they have made a full inquiry into the affairs of the company, and that, having done so, they have formed the opinion that the company has no debts, or that it will be able to pay its debts in full within such period not exceeding three years from the commencement of the winding up as may be specified in the declaration. Such declaration has to be accompanied by a copy of the report of the auditors of the company (prepared, as far as circumstances admit, in accordance with the provisions of this Act) on the profit and loss account of the

company for the period commencing from the date up to which the last such account was prepared and ending with the latest practicable date immediately before the making of the declaration and the balance sheet of the company made out as on the last mentioned date and also embodies a statement of the company's assets and liabilities as at the date.

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

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

- (b) **Scope of Peer Review:** The Statement on Peer Review (ICAI, 2002) lays down the scope of review to be conducted. The peer review process is directed at the attestation services of a practice unit:
- (1) Once a practice unit is selected for review, its attestation engagement records pertaining to the immediately preceding three completed financial years shall be subjected to review.
 - (2) The Review shall focus on:
 - (i) Compliance with Technical Standards
 - (ii) Compliance with Ethical Standards.
 - (iii) Compliance with Professional Standards.
 - (iv) Quality of Reporting.

- (v) Office systems and procedures with regard to compliance of attestation services systems and procedures.
 - (vi) Training Programs for staff (including Articled and Audit Assistants) concerned with attestation functions, including appropriate infrastructure.
- (c) **Audit procedure in respect of “Outstanding Premium and Agents Balance” in Insurance company:** The following are the audit procedures to be followed for verification of outstanding premium and agents’ balances:
- ◆ Scrutinise and review control account debit balances and their nature should be enquired into.
 - ◆ Examine inoperative balances and treatment given for old balances with reference to company rules.
 - ◆ Enquire into the reasons for retaining the old balances.
 - ◆ Verify old debit balances which may require provision or adjustment. Notes of explanation may be obtained from the management in this regard.
 - ◆ Check age-wise, sector-wise analysis of outstanding premium.
 - ◆ Verify whether outstanding premiums have since been collected.
 - ◆ Check the availability of adequate bank guarantee or premium deposit for outstanding premium.
- (d) **Reconciliation of Cost and Financial Accounts:** A cost auditor is ultimately required to express an opinion as to whether the company has maintained proper cost accounting records so as to give a true and fair view of cost of production etc. In arriving at this opinion, the cost auditor is required to ascertain about multitude of information such as cost of raw materials consumed, cost of power and scrap fuel cost of stock, employer costs, provision for depreciation, royalty and technical payment, abnormal cost, etc. Annexure to the cost audit reports requires detailed information in respect of financial position including capital employed, net worth, profit, net rates, operating profit, unit cost of power and fuel, total wages and salaries etc. It is obvious therefore that cost audit cannot be done without reference to financial books, more so in the context of the statutory requirement to have a statement of reconciliation with financial accounts as part of cost audit report. Further the cost statements are to contain a summary of all expenditure incurred by the company and the share in such expenditure attributable to the activities covered by Cost Accounting Records Rules; Overhead expenditure also needs allocation between activities covered by rules and activities not so covered. Naturally this can be done only with reference to financial ledger. Under Part II of Revised Schedule VI to the Companies Act, 1956, quite a few matters which were to be mentioned in the Profit and Loss Account of the company are also to be covered in cost statements such as consumption of raw materials in quantity and value, sale of

finished goods under classified headings in quantity and nature, actual production quantity of value, inventory in quantity of value for each class of goods, etc. A correlation between consumption of raw materials as per cost records and financial records may throw up the need for inquiry into errors, mistakes and manipulation. Material discrepancy between financial records and cost records will be highlighted in the reconciliation statement which would require that the cost auditor may examine deviation before reporting on the same. Thus it is imperative for the cost auditor to refer to financial records.

(e) Propriety elements in CARO, 2003

The following are the Propriety elements in CARO, 2003

- (1) If the company has given or taken loans, secured or unsecured, to/from companies, firms or other parties listed in the register maintained under section 301 of the Companies Act, 1956, whether the rate of interest and other terms and conditions of such loans are *prima-facie* prejudicial to the interest of the company. In this case, the auditor will have to look into the reasonableness of the rate of interest and the terms and conditions of such loans. In other words, he will have to see whether the terms and conditions, including the rate of interest are apparently adverse to the interests of the company, having regard to the circumstances of the company at the time of taking the loans and the terms normally available. He is to exercise his judgment based on commercial considerations like urgency, security offered etc.
- (2) If the overdue amount of the loan given to or taken from companies, firms or other parties listed in the register maintained under section 301 of the Companies Act, 1956, is more than rupees one lakh, what reasonable steps have been taken by the company for recovery/payment of the principal and interest. In making this examination, the auditor would have to consider the facts and circumstances of each case, including the amounts involved. It is not necessary that steps to be taken must necessarily be legal steps. Depending upon the circumstances, period of delay and other similar factors, issue of reminders or sending of advocate's or solicitor's notice may amount to reasonable steps. The auditor should ask the management to give in writing the steps which have been taken. The auditor should arrive at his opinion only after consideration of the management's representations.
- (3) Whether the transactions needed to be entered in a register in pursuance of section 301 of the Companies Act, 1956, have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time. Section 301 requires that every company shall keep one or more registers in which it shall be entered separately the particulars of all contracts or arrangements to which sections 297 and 299 of the Companies Act, 1956 apply. As regards the reasonability of prices, the auditor is not expected to

make a roving market inquiry but to examine price lists, quotations, prices for other parties etc. He should also take into account the factors such as delivery period, quality, quantity involved, credit terms etc.

- (4) Is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employee State Insurance, Income-Tax, Sales Tax, Wealth Tax, Custom Duty, Excise Duty, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the day they became payable, shall be indicated by the auditor.
- (5) Whether the company has made any preferential allotment of shares to parties and companies covered in the register maintained under section 301 of the Companies Act, 1956 and if so whether the price at which shares have been issued is prejudicial to the interest of the company.