

MOCK TEST PAPER -1

FINAL COURSE: GROUP – I

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

SUGGESTED ANSWERS/ HINTS

1. (a) AS-10 "Accounting for Fixed Assets", requires that the items of fixed assets that have been retired from active use and are held for disposal be stated at the lower of their net book value and net realizable value and are shown separately in the financial statements. As per AS-2 "Valuation of Inventories", "inventories" are assets "held for sale in the ordinary course of business, in the process of production for such sale; or in the form of materials or supplies to be consumed in the production process or in the rendering of services.", whereas, the sale of fixed assets cannot be treated as sale arising from the ordinary course of business.

Thus, BEST Ltd's inclusion of fixed assets not in active use and held for disposal, as inventory item in the schedule of inventory is not in line with the requirements of AS-10 and AS-2. Such fixed assets should be stated at lower of net book value and net realizable value and are shown separately in financial statements.

- (b) The contention of the CEO of SHINE 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 SHINE 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 SHINE Co. Ltd.

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

- (c) **Accountability of Export Incentives:** The exporters receive certain incentives (monetary or non-monetary) from the Government of India on export of goods. However due to various procedural delays and laws involved which keep changing frequently, there is generally a delay in actual receipt of the export incentives. Further the receipt of the export incentives may not be assured in certain situations due to frequent changes in the policies of the Government. In such cases, it may be reasonable to presume that the receipt of the incentives is uncertain till the time they are actually received.

As per AS 9 "Revenue Recognition", if at the time of raising the claim for incentive, it is unreasonable to expect ultimate collection, revenue recognition should be postponed. Therefore, as per the accounting standard, if there is uncertainty in the receipt of the amounts, then the revenue in respect of such incentives ought not to be recognized in the books of accounts.

Therefore revenue is to be recognized only when there is reasonable certainty in the receipt of the same. Hence contention of management of TURN EXPORTS Ltd. to record the export incentive on cash basis is correct.

Note : An Alternative view is possible, since the export incentives are due as and when the exports have been made from India, though customs authorities did not acknowledge them as due. This does not mean that an uncertainty arises about its

receipt. If at all customs authorities have an objection it should be at the time of clearance of the goods for export. The only uncertainty is the timing of the receipt of such incentives, but not the incentive itself. Hence TURN EXPORTS Ltd. has to account the export incentives on Accrual basis.

- (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) As part clause (11) of part (I) to the first schedule of 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 accountant unless permitted by the Council.

Under the above clause, the Council permits (among other things) editorship of professional journals. In the instant case, Mr. A, a Chartered Accountant in practice has been appointed editor of a journal related to Stock Market and Mutual Funds – a publication which cannot be called a professional journal.

Hence Mr. A would be guilty of Professional Misconduct.

- (b) Money of clients to be deposited in separate bank account: Clause 10 of Part I of Second Schedule states that a Chartered Accountant shall be deemed to be guilty of professional misconduct if "he fails to keep money of his clients in separate banking account or to use such money for the purpose for which they are intended."

B & Co. received the money in January, 2011 which is to be paid only in July 2011; hence it should be deposited in a separate bank account. Since in this case B & Co. have failed to keep the sum of ₹ 3 lakhs received on behalf of their client in a separate Bank Account, it amounts to professional misconduct under clause 10 of part I of Second Schedule.

- (c) Responding to Tenders: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 lays down guidelines for responding to tenders, etc. As per the guidelines if a matter relates to any services other than audit, members can respond to any tender. Further, in respect of a non-exclusive area, members are permitted to pay reasonable amount towards earnest money/security deposits.

In the instance case, since computerization of land revenue records does not fall within exclusive areas for chartered accountants, M/s C & Co. can respond to tender as well as deposit ₹ 1,00,000 as earnest deposit and has not committed any professional misconduct.

- (d) Disclosure of Client's Information: Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 deals with the professional misconduct relating to the disclosure of information by a chartered accountant in practice

relating to the business of his clients to any person other than his client without the consent of his client or otherwise than as required by any law for the time being in force would amount to breach of confidence. The Code of Ethics further clarifies that such a duty continues even after completion of the assignment. The Chartered Accountant may however, disclose the information in case it is required as a part of performance of his professional duties. In the given case, Mr. D has disclosed vital information of his client's business without the consent of the client under the impression that it will help the nation to compete with other countries at International level. Thus it is a professional misconduct covered by clause (1) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

3. (a) As per SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatements for accounting estimates.
- (i) The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.
 - (ii) How Management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed, in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.
 - (iii) The estimation making process adopted by the management including
 - (1) The method, including where applicable the model, used in making the accounting estimates
 - (2) Relevant controls
 - (3) Whether management has used an expert?
 - (4) The assumption underlying the accounting estimates
 - (5) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and
 - (6) Whether and, if so, how the management has assessed the effect of estimation uncertainty.
- (b) According to SRS 4410, "Engagement to Compile Financial Information" if an accountant becomes aware of material misstatements, the accountant should persuade the management to carry out necessary amendments in the financial statements or other compiled financial information. If such amendments are not made and the financial statements are still considered to be misleading the accountant should withdraw from the engagement. Hence, in this case, there is a clear violation of SRS 4410.
- (c) SA 620 states that while using the work of an expert, auditor should consider the materiality of the item, nature and complexity of the item, the other audit evidence available and professional qualifications, experience and reputation in the field of the concerned expert.

The auditor should ensure that the expert has used appropriate source data, has made consistent assumptions, has applied correct methods and that results of expert's work are in line with auditor's overall knowledge of the business and match with results of his audit procedures. The auditor should also ensure that substance of expert's findings is properly reflected in the financial information.

- (d) **Risk Factors while applying sampling techniques:** 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.
- 4. (a) **Non-performing Assets:** RBI has laid down norms for classification of assets and provisioning norms for NPAs. However, certain exceptions to these norms are discussed below:
 - (i) Temporary deficiencies, e.g., non availability of current drawing power due to non-receipt of latest stock statement, temporary delay in renewals of limits on due date, etc.
 - (ii) *Natural Calamities:* Where, in the wake of natural calamities, short-term agricultural loans are converted into term loans or there is rescheduling of repayment period or fresh short-term loans are sanctioned, the term loan as well as fresh short term loan may be treated as current dues and need not be classified as NPA.
 - (iii) *Facilities Backed by Central Government Guarantees:* Credit facilities backed by guarantee of the Central Government though overdue should be treated as NPA only when the government repudiates its guarantee when invoked (this exemption is only for the purpose of asset classification and provisioning and not for the purpose of recognition of income).
 - (iv) Advances to "On Lending" arrangements are also exempted under this category.
- (b) The following audit procedure is to be followed for verification of outstanding premium and agents balances in the case of Insurance Company.
 - (1) Scrutinise and review control account debit balances and their nature should be enquired into.
 - (2) Examine inoperative balances and treatment given for old balances with reference to company rules.
 - (3) Enquire the reasons for returning the old balances.

- (4) Verify old debit balances which may require provision or adjustment. Notes of explanation may be obtained from the management in this regard.
 - (5) Check age-wise, sector-wise analysis of outstanding premium.
 - (6) Verify whether outstanding premiums have since been collected.
 - (7) Check the availability of adequate bank guarantee or premium deposit for outstanding premium.
- (c) During the course of audit, if the auditor notices that there are some serious irregularities in the working of the society he may report these special matters to the Registrar, drawing his specific attention to the points. The Registrar on receipt of such a special report may take necessary action against the society. In the following cases, for instance a special report may become necessary:
- (i) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.
 - (ii) Detection of fraud relating to expenses, purchases, property and stores of the society.
 - (iii) Specific examples of mis-management. Decisions of management against co-operative principles.
 - (iv) In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.
- (d) **Audit of equipment leasing finance company**
- The auditor should:
- (i) Ascertain whether the Non Banking Financial Company (NBFC) has an adequate appraisal system for extending equipment leasing finance.
 - (ii) Verify whether there is an adequate system in place for ensuring installation of assets and their periodical physical verification. In some major transactions, arrange for physical verification of the leased assets so as to dispel any doubts that equipment leasing finance was not extended without the corresponding assets being created.
 - (iii) Ascertain that the NBFC has an adequate system for monitoring whether the assets have been adequately insured against and regular maintenance of the leased asset is being carried out by the lessee.
 - (iv) Verify the lease agreement entered into with the lessee in respect of the equipment given on lease.
 - (v) Verify whether the Accounting Standard issued by the Institute of Chartered Accountants of India in respect of "Accounting for Lease" has been compulsorily followed.
5. (a) As per SA 610 (Revised) "Using the Work of Internal Auditor" the statutory auditor has to consider the following before placing reliance on the same".
- (i) Organizational status – whether the same is done internally or by an external agency.

- (ii) Scope of work – What is the nature and depth of the coverage of the assignment.
- (iii) Technical competence – Whether the internal auditor is technically competent to do the work i.e. having adequate technical training and proficiency.
- (iv) Due professional care – Whether his work and reports appear to be properly planned, supervised reviewed and documented.
- (v) Audit Evidence - Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;
- (vi) Conclusions - Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and
- (vii) Response to unusual matters - Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

If the above factors are not satisfactory, the statutory auditor will have to modify his audit program and increase the verification to be carried out.

(b) 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 advances 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 shows the true picture.

- (c) **Key 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.

6. (a) (i) **Disposal of Fixed Assets:** Under CARO, 2003, an auditor is required to state if substantial part of the fixed assets have been disposed off during the year, whether it has affected the going concern. This clause requires the auditor to carry out adequate audit procedures to satisfy himself that the company shall be able to continue as going concern for the foreseeable future despite the sale of substantial part of the fixed assets.

Accordingly, in the instant case, the auditor should satisfy himself as to whether disposal off of 1/3rd of fixed assets during the year had any effect on the going concern assumption on account of such sale of fixed assets. The auditor is required to exercise his professional judgement to determine whether disposal off of one-third of total assets constitutes substantial part or not. Depending upon the judgement arrived at by the auditor, he shall report whether substantial part of fixed assets have been disposed off or not during the year and it has affected or not affected the going concern status of the company. Alternatively, in case the auditor is of the opinion that it constitutes substantial sale but the going concern assumption is appropriate because of mitigating factors then he has to ensure that the same are disclosed in the financial statements or else he shall have to modify the auditor report. The manner of reporting shall also be modified appropriately in case the going

concern assumption is resolved or not.

- (ii) **Utilisation of Term Loans:** Under CARO, 2003, an auditor is required to comment whether term loans were applied for the purpose for which the loans were obtained.

The auditor should examine the terms and conditions of the term loan with the actual utilisation of the loans. If the auditor finds that the fund has not been utilized for the purpose for which they were obtained, the report should state the fact.

In the instant case, since term loan taken for the purpose of R&D equipment has been utilized for purchase of car which has no relation with R&D equipment. Therefore, car though used for R&D Director cannot be considered as R&D equipment. The auditor should state the fact in his report that the out of term loan of R&D, ₹ 12 lakhs was not utilised for the purpose of acquiring the R & D equipment.

- (b) Section 209(1) of the Companies Act, 1956 requires that every company shall keep proper books of account with respect to the following items:
 - (i) all sums of money received and expended by the company and the matters in respect of which the receipts and expenditure take place;
 - (ii) all sales and purchases of goods by the company;
 - (iii) the assets and liabilities of the company; and
 - (iv) in the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilisation of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particulars in the books of account.

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

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

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

- (c) **Declaration of Interim Dividend:** Interim dividend can be declared by the Board of Directors only if there is an authorisation in the Articles of Association to do so. An interim accounts should be prepared to ascertain the amount of profits that has been made. Assuming that interim accounts have been prepared and they disclose profits sufficient for the declaration of dividend after making appropriate provisions for depreciation, compulsory transfers to reserves, bad debts and other contingencies, only then the proportion of profits which have to be distributed as interim dividend may be decided.

In the present case, the company has suffered a net loss at the end of the year, obviously the directors have miscalculated the performance of the company about the second half of the year. If the company had a sufficient balance in the profit and loss account as at the beginning of the year, the dividend declared could be paid out of the same. The balance had also to be sufficient to transfer the relevant amounts to reserves. In such a case the auditor need not report anything. Moreover, if such balance was not available, the dividend could also be paid out of reserves. In the situation of dividends to be declared out of reserves, a maximum of only 10% dividend is allowed. In this case, since the dividend was declared @ 30%, the said provisions would have been violated and thus the auditor would have to mention the said fact. If, however, there is neither balance in the profit and loss account nor any reserves are available, the dividend would be clearly paid out of capital. The auditor would have to qualify his report mentioning the fact of the dividend having been paid out of capital.

7. (a) **Flow-Chart Technique for evaluation of Internal Control:** This technique can be resorted to for evaluation of the Internal Control System. It is a graphic presentation of internal controls in the organisation and is normally drawn up to show the controls in each section or sub-section.

As distinct from a narrative form, it provides the most concise and comprehensive way for reviewing the internal controls and the evaluator's findings. In a flow chart narratives are reduced to the minimum and by that process, it can successfully bring the whole control structure, specially the essential parts thereof, in a condensed but wholly meaningful manner. Every details relevant from the control point of view and the details about how an operation is performed can be included in the flowchart.

Essentially, a flow chart is a diagram full with lines and symbols and if judicious use of them can be made, it is probably an effective way of presenting the state of internal controls in the client's organisation. A properly drawn up flow chart can provide a neat visual picture of the whole activities of the section or department involving flow of documents and activities. More specifically it can show –

- (i) at what point a document is raised internally or received from external sources;
- (ii) the number of copies in which a document is raised or received;
- (iii) the intermediate stages set sequentially through which the document and the activity pass;
- (iv) distribution of the documents to various sections, department or operations;
- (v) checking authorisation and matching at relevant stages;
- (vi) filing of the documents; and
- (vii) final disposal by sending out or destruction.

A flow chart is normally a horizontal one in which documents and activities are shown to flow horizontally from section to section and concerned sections are shown as the vertical column needs. These can be sales, purchase, wages, production etc.

Purchases can be linked with sundry creditors and payments, sales with sundry debtors and collections. By this process, a flow chart will become self contained, complete and meaningful for evaluation of internal controls.

Generally, a questionnaire is also enclosed with a flow chart, incorporating questions, the answers to which are to be looked into from the flow chart.

(b) Auditing procedures using CAATs: CAATs may be used in performing various auditing procedures, including the following:

1. Tests of details of transactions and balances, for example, the use of audit software for recalculating interest or the extraction of invoices over a certain value from computer records;
2. Analytical procedures, for example, identifying inconsistencies or significant fluctuations;
3. Tests of general controls, for example, testing the set-up or configuration of the operating system or access procedures to the program libraries or by using code comparison software to check that the version of the program in use is the version approved by management ;
4. Sampling programs to extract data for audit testing;
5. Tests of application controls, for example, testing the functioning of a programmed control; and
6. Re-performing calculations performed by the entity's accounting systems.

(c) Haphazard Sampling: In haphazard selection, the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

Haphazard selection of sample, may be an acceptable alternative to random selection of sample, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units.

When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily located, as they may not be representative.

(d) Section 62 of the Companies Act, 1956 lays down the civil liability for misstatement in a prospectus issued to invite persons to subscribe for shares in or debentures of a company. The professional accountant will in such a case be liable to pay compensation to every person who subscribes for any shares or debentures on the faith of the prospectus for any loss or damage sustained because of an untrue statement made by him as an expert.

However, professional accountants will not be liable if they can prove that:

- (i) the prospectus was issued without his knowledge or consent and that on becoming aware of its issue he forthwith gave reasonable public notice that it was issued without his knowledge or consent; or
- (ii) he withdrew his consent in writing before delivery of the prospectus for registration; or
- (iii) after the delivery of prospectus for registration but before allotment of shares,

on becoming aware of the untrue statement, he withdrew his consent in writing and gave reasonable public notice of the withdrawal, and of the reasons therefore; or

- (iv) he was competent to make the statement and that he had reasonable grounds to believe and did up to the time of allotment of the shares or debentures believe that the statement was true.
- (e) **True and Fair Cost of Production:** 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.