1

Auditing Standards, Statements and Guidance Notes – An Overview

The Council of the ICAI has issued following Quality Control and Engagement Standards

S. No.	No. of Standard	Title of the Standard	*Effective Date
1	SQC 1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements	April 1, 2009
2	SA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	April 1, 2010
3	SA 210	Agreeing the Terms of Audit Engagements	April 1, 2010
4	SA 220	Quality Control for an Audit of Financial Statements	April 1, 2010
5	SA 230	Audit Documentation	April 1, 2009
6	SA 240	The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements	April 1, 2009
7	SA 250	Consideration of Laws and Regulations in an Audit of Financial Statements	April 1, 2009
8	SA 260	Communication with Those Charged with Governance	April 1, 2009
9	SA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	April 1, 2010
10	SA 299	Responsibility of Joint Auditors	April 1, 1996
11	SA 300	Planning an Audit of Financial Statements	April 1, 2008
12	SA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment	April 1, 2008
13	SA 320	Materiality in Planning and Performing an Audit	April 1, 2010
14	SA 330	The Auditor's Responses to Assessed Risks	April 1, 2008
15	SA 402	Audit Considerations Relating to an Entity Using a Service Organization	April 1, 2010
16	SA 450	Evaluation of Misstatements Identified during the Audits	April 1, 2010
17	SA 500	Audit Evidence	April 1, 2009
18	SA 501	Audit Evidence - Specific Considerations for Selected Items	April 1, 2010
19	SA 505	External Confirmations	April 1, 2010
20	SA 510	Initial Audit Engagements-Opening Balances	April 1, 2010
21	SA 520	Analytical Procedures	April 1, 2010
22	SA 530	Audit Sampling	April 1, 2009
23	SA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	April 1, 2009
24	SA 550	Related Parties	April 1, 2010
25	SA 560	Subsequent Events	April 1, 2009
26	SA 570	Going Concern	April 1, 2009
27	SA 580	Written Representations	April 1, 2009
28	SA 600	Using the Work of Another Auditor	April 1, 2002
29	SA 610	Using the Work of Internal Auditors	April 1, 2010
30	SA 620	Using the Work of an Auditor's Expert	April1, 2010
31	SA 700**	Forming an Opinion and Reporting on Financial Statements	April 1, 2011
32	SA 705**	Modifications to the Opinion in the Independent Auditor's Report	April 1, 2011
33	SA 706**	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	April 1, 2011
34	SA 710	Comparative Information – Corresponding Figures and Comparative Financial Statements	April 1, 2011
35	SA 720	The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements	April 1, 2010
36	SA 800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Framework	April 1, 2011
37	SA 805	Special Considerations-Audits of Single Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement	April 1, 2011
38	SA 810	Engagements to Report on Summary Financial Statements	April 1, 2011
39	SRE 2400	Engagements to Review Financial Statements	April 1, 2010

40	*SRE 2410*	*Review of Interim Financial Information Performed by the Independent Auditor of the Entity*	*April 1, 2010*
41	*SAE 3400*	*The Examination of Prospective Financial Information*	*April 1, 2007*
42	*SAE 3402*	*Assurance Reports on Controls At a Service Organisation*	*April 1, 2011*
43	*SRS 4400*	*Engagements to Perform Agreed Upon Procedures Regarding Financial Information*	*April 1, 2004*
44	*SRS 4410*	*Engagements to Compile Financial Information*	*April 1, 2004*

* *Effective date means that the SA is effective for audits of the financial statements for periods beginning on or after the specified date.*

** *"The Council, in partial modification of the decision taken by it at its 291st meeting held in December, 2009, decided that the effective date/applicability of the following Standards on Auditing a) SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements";b) SA 705, "Modifications to the Opinion in the Independent Auditor's Report";c) SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" be postponed by one year and consequently the said Standards shall now be effective/applicable for audits of financial statements for periods beginning on or after 1st April, 2012 (instead of audits of financial statements for periods beginning on or after 1st April, 2011 as was earlier decided and referred to above).*

1.1 A brief summary of each Standard issued by AASB is given below:

1.1.1 Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements".

It is a mother Standard for all other Standards and is all pervasive Standard in respect of quality control. As the name suggests, the SQC 1 contains extensive requirements in relation to establishment and maintenance of a system of quality control (QC) in the audit firms as well as even for sole practitioners. The important elements of a system of quality control discussed by the Standard include Elements of a System of Quality Control, Leadership Responsibilities for Quality Within the Firm, Ethical Requirements – Independence, Acceptance and Continuation of Client Relationships and Specific Engagements, Human Resources - Assignment of Engagement Team, Engagement Performance - Consultation, Differences of Opinion, Engagement Quality Control Review and Documentation of the Engagement Quality Control Review - Engagement Documentation.

The Standard is recommendatory from April 1, 2008 and mandatory from April 1, 2009.

1.1.2 SA 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing-it establishes the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with SAs. Specifically, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the SAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the SAs. It has to be adapted as necessary in the circumstances when applied to audits of other historical financial information. This SA requires that the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

The SAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:

- *Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control (further expounded in SA 315 and SA 330).*
- *Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks (further expounded in SA 500 and SA 501).*
- *Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained (further expounded in SA 700, SA 705, SA 706 and SA 720).*

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.3 SA 210: Agreeing the Terms of Audit Engagements- It is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 26, "Terms of Audit Engagements" issued by the Institute in 2003. The revised Standard deals with the auditor's responsibilities in agreeing the terms of audit engagement with management and, where appropriate, those charged with governance. SA 210 establishes certain preconditions for an audit, responsibility for which rests with management or those charged with governance. SA 210 also deals with the requirements relating to preconditions for an audit, agreement on audit engagement terms, recurring audits, acceptance of a change in the terms of the audit engagement and additional considerations in engagement acceptance. The appendices to revised SA 210 contain the illustrative example of an audit engagement letter and the factors determining the acceptability of general purpose frameworks.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.4 SA 220 : Quality Control for an Audit of Financial Statements- SA 220 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 17, "Quality Control for Audit Work" issued by the Institute in 1999. The revised Standard deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. It also addresses, where applicable, the responsibilities of the engagement quality control reviewer. Revised SA 220 also deals with the aspects relating to leadership responsibilities for quality on audits, relevant ethical requirements, acceptance and continuance of client relationships and audit engagement, assignment of engagement teams, engagement performance, monitoring and documentation requirements.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.5 SA 230: Audit Documentation: SA 230 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 3, "Documentation" issued by the Institute in 1985. The new Standard deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. SA 230 also deals with the requirements of timely preparation of audit documentation, documentation of the audit procedures performed and audit evidence obtained and assembly of the final audit file. SA 230 also outlines about vesting of property of working papers with the Auditor. SQC 1 read with SA 230 spells out two essential principles viz. period of maintaining working papers and assembly of audit file by the auditor.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.6 SA 240: The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements-The Standard adopts a risk-based approach to auditor's responsibility relating to fraud in an audit of financial statements. It, therefore, explains how the principles enunciated in SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" and SA 330, "The Auditor's Responses to Assessed Risks" would be applied in case of consideration of fraud in an audit of financial statements.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.7 SA 250: Consideration of Laws and Regulations in an Audit of Financial Statements- SA 250 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 21, "Considerations of Laws and Regulations in an Audit of Financial Statements" issued by the Institute in 2001. The revised Standard deals with the auditor's responsibility to consider laws and regulations when performing an audit of financial statements. Revised SA 250 also deals with the effect of laws and regulations, responsibility of management for compliance with laws and regulations, responsibility of the auditor, audit procedures and reporting of identified or suspected non-compliance and documentation requirements.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.8 SA 260: Communication with Those Charged with Governance-SA 260 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 27, "Communications of Audit Matters with Those Charged with Governance" issued by the Institute in 2003. This Standard deals with the auditor's responsibility to communicate with those charged with governance in relation to an audit of financial statements. SA 260 also describes the requirements regarding communication with those charged with governance and regarding matter to be communicated and documentation required. This standard also spells out the distinction between the Management and Those Charged with Governance.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.9 SA 265: Communicating Deficiencies in Internal Control to Those Charged with Governance and Management-SA 265 is a new Standard on Auditing which deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements. SA 265 defines the terms "Deficiency in internal control" and "Significant deficiency in internal control". This SA also deals with the aspects like determination of whether deficiencies in internal control have been identified, whether it is significant deficiencies in internal control and communicating deficiencies in internal control. This standard somehow supplements the concept of 'Letter of Weakness.'

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.10 SA 299: Responsibility of Joint Auditors - This SA deals with the professional responsibilities which the auditors undertake in accepting appointments as joint auditors. The SA, inter alia, lays down that the joint auditors should, normally, by mutual discussion, divide the audit work among themselves. The division of work among joint auditors as also the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity. The SA also states that each joint auditor is responsible only for the work allotted to him, whether or not he has prepared a separate report on the work performed by him. The SA describes the areas for which joint auditors are jointly and severally responsible. As per the SA, each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with generally accepted audit procedures. It also deals with the reporting responsibilities of the joint auditors. This standard very specifically states that the majority opinion would not be binding upon the other joint auditor(s).

The SA became effective for all audits relating to accounting periods commencing on or after April 1, 1996.

1.1.11 SA 300: Planning an Audit of Financial Statements-This Standard on Auditing (SA) deals with the auditor's responsibility to plan an audit of financial statements. As per this SA the objective of the auditor is to plan the audit so that it will be performed in an effective manner.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2008.

1.1.12 SA 315: Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment-The Standard deals with the auditor's responsibility to obtain an understanding of the entity and its environment and using that understanding to identify and assess the risks of material misstatement at the financial statement level and assertion level.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2008.

1.1.13 SA 320: Materiality in Planning and Performing an Audit-SA 320 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 13, "Audit Materiality" issued by the Institute in 1997. The revised Standard deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. This SA also deals with the requirements of determining materiality and performance materiality when planning the audit, revision as the audit progresses and documentation requirements.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.14 SA 330: The Auditor's Responses to Assessed Risks-SA 330 is a new Standard on Auditing which deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315 at the financial statement level and assertion level. This SA also deals with the aspects relating to overall responses to assessed risks, audit procedures responsive to the assessed risks of material misstatement at the assertion level, adequacy of presentation and disclosure, evaluating the sufficiency and appropriateness of audit evidence and documentation requirements.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2008.

1.1.15 SA 402: Audit Considerations Relating to an Entity Using a Service Organisation -SA 402 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 24, "Audit Considerations Relating to Entities Using Service Organisations" issued by the Institute in 2002. The revised Standard deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organizations. SA 402 also deals with the aspects like obtaining an understanding of the services provided by a service organisation, including internal control, responding to the assessed risks of material misstatement, Type 1 and Type 2 reports, fraud, non-compliance with laws and regulations and uncorrected misstatements in relation to activities at the service organisation and reporting by the user auditor.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.16 SA 450: Evaluation of Misstatements Identified During the Audit-SA 450 is a new Standard on Auditing which deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. SA 450 defines the terms "Misstatement" and "Uncorrected misstatements". This SA also deals with the aspects like accumulation of identified misstatements, consideration of identified misstatements as the audit progresses, communication and correction of misstatements, evaluating the effect of uncorrected misstatements, written representation and documentation.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.17 SA 500: Audit Evidence-SA 500 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 5, "Audit Evidence" issued by the Institute in 1988. The revised Standard is quite detailed in terms of audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. This SA also deals with the requirements of obtaining sufficient appropriate audit evidence, how information to be used as audit evidence, how to select items for testing to obtain audit evidence and procedures in case of inconsistency in, or doubts over reliability of, audit evidence.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.18 SA 501: Audit Evidence—Specific Considerations for Selected Items-SA 501 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 34, "Audit Evidence – Additional Considerations for Specific Items" issued by the Institute in 2005. The revised Standard deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence in accordance with SA 330, SA 500 (Revised) and other relevant SAs, with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements. Revised SA 501 also deals with the requirements and application of the aspects relating to inventory, litigation and claims and segment information.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.19 SA 505: External Confirmations-SA 505 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 30, "External Confirmations" issued by the Institute in 2003. The revised Standard deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 330. Revised SA 505 also deals with the requirements and application of the aspects relating to external confirmation procedures, management's refusal to allow the auditor to send a confirmation request, results of the external confirmation procedures, negative confirmations and evaluating the evidence obtained.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.20 SA 510: Initial Audit Engagements- Opening Balances-SA 510 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 22, "Initial Engagements- Opening Balances" issued by the Institute in 2001. The revised Standard establishes the principles regarding audit of opening balances in case of initial engagements, i.e., when the financial statements are audited for the first time or when the financial statements for the preceding period were audited by another auditor. This SA also deals with the audit procedures and audit conclusions and reporting requirements in case of initial audit engagements.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.21 SA 520: Analytical Procedures-SA 520 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 14, "Analytical Procedures" issued by the Institute in 1997. The revised Standard deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements. Revised SA 520 also deals with the requirements and application of the aspects relating to substantive analytical procedures, analytical procedures that assist when forming an overall conclusion and investigating results of analytical procedures.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.22 SA 530: Audit Sampling-SA 530 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 15, "Audit Sampling" issued by the Institute in 1998. The revised Standard applies when the auditor has decided to use audit sampling in performing audit procedures. It also deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample. This SA also deals with the requirements relating to sample design, size and selection of items for testing, performing audit procedures, nature and cause of deviations and misstatements, projecting misstatements and evaluating results of audit sampling. This SA contains four Appendices also.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.23 SA 540: Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures- SA 540 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 18, "Audit of Accounting Estimates" issued by the Institute in 2000. The revised Standard deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 315 and SA 330 and other SAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias. Considering the application of Ind AS/ IFRS in times to come and resulting estimates to made, this Standard assumes special significance for the auditors.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.24 SA 550: Related Parties-SA 550 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 23, "Related Parties" issued by the Institute in 2001. The revised Standard deals with the auditor's responsibilities regarding related party relationship and transactions when performing an audit of financial statements. This standard also deals with the risk assessment procedures and related activities, identification and assessment of the risks of material misstatement associated with related party relationships and transactions, responses to the risks of material misstatement associated with related party relationships and transactions and evaluation of the accounting for and disclosure of identified related party relationships and transactions etc.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.25 SA 560: Subsequent Events-SA 560 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 19, "Subsequent Events" issued by the Institute in 2000. The revised Standard deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. SA 560 also deals with the events occurring between the date of the financial statements and the date of the auditor's report, facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued and facts which become known to the auditor after the financial statements have been issued.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.26 SA 570 Going Concern-SA 570 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 16, "Going Concern" issued by the Institute in 1998. The revised Standard is quite detailed in terms of auditor's responsibility in the audit of financial statements with respect to management's use of the going concern assumption in the preparation and presentation of the financial statements. SA 570 requires the auditor to inquire of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern. SA 570 also deals with the requirements of risk assessment procedures and related activities, evaluating management's assessment, additional procedures, audit conclusions and reporting, use of going concern assumption etc. The standard also discusses the principles when mitigating factors are present vis-à-vis Going Concern of the enterprise.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.27 SA 580: Written Representations-SA 580 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 11, "Representations by Management" issued by the Institute in 1996. The revised Standard is quite detailed in terms of the duties and objectives of the auditors regarding the acknowledgement by the management that it is fulfilling its responsibility relating to preparation and presentation of financial statements and internal controls, the various forms of management representations, situations where management representations are unreliable or where the management refuses to provide requested representations.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.28 SA 600 : Using the Work of Another Auditor - This SA discusses the procedures to be applied in situations where an independent auditor reporting on the financial statements of an entity, uses the work of an independent auditor with respect to the financial statements of one or more divisions or branches included in the financial statement of the entity. The Statement also discusses the principal auditor's responsibility in relation to his use of the work of other auditor. This Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 1995.

When the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit.

The auditor should consider whether the auditor's own participation is sufficient to be able to act as the principal auditor.

When planning to use the work of another auditor, the principal auditor should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.

The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment.

The principal auditor should consider the significant findings of the other auditor.

There should be sufficient liaison between the principal auditor and the other auditor.

The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor.

When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.

When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/ branches/subsidiaries or other components audited by other auditors.

1.1.29 SA 610: Using the work of Internal Auditors: SA 610 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 7, "Relying Upon the Work of an Internal Auditor" issued by the Institute in 1989. The revised Standard deals with the external auditor's responsibilities regarding the work of internal auditors. This SA also defines the terms "Internal audit function" and "Internal auditors". SA 610 also deals with the aspects like determining whether and to what extent to use the work of the internal auditors, using specific work of the internal auditors and documentation.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.30 SA 620: Using the Work of an Auditor's Expert-SA 620 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 9 "Using the Work of An Expert" issued by the Institute in 1991. The revised Standard deals with the auditor's responsibilities regarding the use of an individual or organisation's work in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence. Revised SA 620 also deals with the requirements and application of the aspects relating to determining the need for an auditor's expert, nature, timing and extent of audit procedures, the competence, capabilities and objectivity of the auditor's expert, obtaining an understanding of the field of expertise of the auditor's expert, agreement with the auditor's expert, evaluating the adequacy of the auditor's expert's and reference to the auditor's expert in the auditor's report. This standard should be read in conjunction with SA 500 because Expert's opinion also serves as audit evidence in appropriate cases.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.31 SA 700: Forming an Opinion and Reporting on Financial Statements-SA 700 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 28, "The Auditor's Report on Financial Statements" issued by the Institute in 2003. The revised Standard deals with the auditor's responsibilities to form an opinion on the financial statements and the form and content of the auditor's report issued as a result of an audit of financial statements. Revised SA 700 also deals with the requirements relating to forming an opinion on the financial statements, form of opinion, auditor's report, supplementary information presented with the financial statements and the application guidance of these aspects. Appendix to revised SA 700 also contains the Illustrative Formats of Auditors' Reports on Financial Statements.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

1.1.32 SA 705: Modifications to the Opinion in the Independent Auditor's Report. This Standard on Auditing (SA) deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary. The objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that are necessary when:

(a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

1.1.33 SA 706: Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report -It deals with additional communication in the auditor's report when the auditor considers it necessary to: Draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or Draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report. Other Standards on Auditing (SAs) may contain specific requirements for the auditor to include Emphasis of Matter paragraphs or Other Matter paragraphs in the auditor's report. In those circumstances, the requirements in this SA regarding the form and placement of such paragraphs apply. The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

(a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or

(b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

1.1.34 SA 710: Comparative Information—Corresponding Figures and Comparative Financial Statements-SA 710 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 25, "Comparatives" issued by the Institute in 2002. The revised Standard deals with the auditor's responsibilities regarding comparative information in an audit of financial statements. This SA defines the terms 'Corresponding figures', 'Comparative information' and 'Comparative financial statements'. Revised SA 710 also deals with the requirements and application of the aspects relating to audit procedures and audit reporting relating to Corresponding Figures and Comparative Financial Statements. Appendix to revised SA 710 contains the 'Example of Auditors' Reports'.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

1.1.35 SA 720: The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements-This Standard on Auditing (SA) deals with the auditor's responsibility regarding other information in documents containing audited financial statements and the auditor's report thereon. As per SA 720 the objective of the auditor is to respond appropriately when documents containing audited financial statements and the auditor's report thereon include other information that could undermine the credibility of those financial statements and the auditor's report. This SA also deals with the requirements related to reading other information, material inconsistencies and material misstatements of fact.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.36 SA 800: Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks- This SA deals with special considerations in the application of those SAs to an audit of financial statements prepared in accordance with a special purpose framework. It does not override the requirements of the other SAs; nor does it purport to deal with all special considerations that may be relevant in the circumstances of the engagement. The objective of the auditor, when applying SAs in an audit of financial statements prepared in accordance with a special purpose framework, is to address appropriately the special considerations that are relevant to:

(a) The acceptance of the engagement;

(b) The planning and performance of that engagement; and

(c) Forming an opinion and reporting on the financial statements.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

1.1.37 SA 805: Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement-This SA deals with special considerations in the application of those SAs to an audit of a single financial statement or of a specific element, account or item of a financial statement. The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework. If prepared in accordance with a special purpose framework, SA 800 also applies to the audit. It does not apply to the report of a component auditor, issued as a result of work performed on the financial information of a component at the request of a group engagement team for purposes of an audit of group financial statements. Further it does not override the requirements of the other SAs; nor does it purport to deal with all special considerations that may be relevant in the circumstances of the engagement. The objective of the auditor, when applying SAs in an audit of a single financial statement or of a specific element, account or item of a financial statement, is to address appropriately the special considerations that are relevant to:

(a) The acceptance of the engagement;
(b) The planning and performance of that engagement; and
(c) Forming an opinion and reporting on the single financial statement or on the specific element, account or item of a financial statement.

This SA is effective for audits of single financial statements or of specific elements, accounts or items for periods beginning on or after April 1, 2011. In the case of audits of single financial statements or of specific elements, accounts or items of a financial statement prepared as at a specific date, this SA is effective for audits of such information prepared as at a date on or after April 1, 2011.

1.1.38 SA 810: Engagements to Report on Summary Financial Statements- This SA deals with the auditor's responsibilities when undertaking an engagement to report on summary financial statements derived from financial statements audited in accordance with SAs by that same auditor. The objectives of the auditor are to:

(a) Determine whether it is appropriate to accept the engagement to report on summary financial statements;
(b) Form an opinion on the summary financial statements based on an evaluation of the conclusions drawn from the evidence obtained; and
(c) Express clearly that opinion through a written report that also describes the basis for that opinion.

The auditor shall, ordinarily, accept an engagement to report on summary financial statements in accordance with this SA only when the auditor has been engaged to conduct an audit in accordance with SAs of the financial statements from which the summary financial statements are derived.

Before accepting an engagement to report on summary financial statements, the auditor shall

(a) Determine whether the applied criteria are acceptable;

(b) Obtain the agreement of management that it acknowledges and understands its responsibility:

i. For the preparation of the summary financial statements in accordance with the applied criteria;
ii. To make the audited financial statements available to the intended users of the summary financial statements without undue difficulty (or, if law or regulation provides that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements, to describe that law or regulation in the summary financial statements); and
iii. To include the auditor's report on the summary financial statements in any document that contains the summary financial statements and that indicates that the auditor has reported on them.

(c) Agree with management the form of opinion to be expressed on the summary financial statements.

If the auditor concludes that the applied criteria are unacceptable or is unable to obtain the agreement of management set out above, the auditor shall not accept the engagement to report on the summary financial statements, unless required by law or regulation to do so. An engagement conducted in accordance with such law or regulation does not comply with this SA. Accordingly, the auditor's report on the summary financial statements shall not indicate that the engagement was conducted in accordance with this SA. The auditor shall include appropriate reference to this fact in the terms of the engagement. The auditor shall also determine the effect that this may have on the engagement to audit the financial statements from which the summary financial statements are derived.

This SA is effective for engagements for periods beginning on or after April 1, 2011.

1.1.39 SRE 2400: Engagements to Review Financial Statements – The purpose of this Standard on Review Engagements (SRE) is to establish standards and provide guidance on the practitioner's professional responsibilities when a practitioner, who is not the auditor of an entity, undertakes an engagement to review financial statements and on the form and content of the report that the practitioner issues in connection with such a review. A practitioner, who is the auditor of the entity, engaged to perform a review of interim financial information performs such a review in accordance with SRE 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity". Consequent upon the requirements of Clause 41 of the Listing Agreement, this Standard also comes handy to the members of ICAI engaged as Reviewers of Financial Statements.

This SRE is directed towards the review of financial statements. However, it is to be applied, adapted as necessary in the circumstances, to engagements to review other historical financial information. Guidance in the Standards on Auditing (SAs) may be useful to the practitioner in applying this SRE.

The objective of a review of financial statements is to enable a practitioner to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the practitioner's attention that causes the practitioner to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework (negative assurance).

This SRE is effective for reviews of financial statements for periods beginning on or after April 1, 2010.

1.1.40 SRE 2410: Review of Interim Financial Information Performed by the Independent Auditor of the Entity– The purpose of this Standard on Review Engagements (SRE) is to establish standards and provide guidance on the auditor's professional responsibilities when the auditor undertakes an engagement to review interim financial information of an audit client, and on the form and content of the report. The term "auditor" is used throughout this SRE, not because the auditor is performing an audit function but because the scope of this SRE is limited to a review of interim financial information performed by the independent auditor of the financial statements of the entity.

For purposes of this SRE, interim financial information is financial information that is prepared and presented in accordance with an applicable financial reporting framework2 and comprises either a complete or a condensed set of financial statements for a period that is shorter than the entity's financial year.

This SRE is effective for reviews of interim financial information for periods beginning on or after April 1, 2010.

1.1.41 SAE 3400: The Examination of Prospective Financial Information-The purpose of this Standard on Assurance Engagement (SAE) is to establish standards and provide guidance on engagements to examine and report on prospective financial information including examination procedures for best-estimate and hypothetical assumptions. This SAE does not apply to the examination of prospective financial information expressed in general or narrative terms, such as that found in management's discussion and analysis in an entity's annual report, though many of the procedures outlined herein may be suitable for such an examination. Here it would be worthwhile to mention that Clause 3 of Part I of Second Schedule to the Chartered Accountants Act, 1949 as amended states that a member of ICAI into practice shall be deemed guilty of professional misconduct if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in manner which may lead to the belief that he vouches for the accuracy of the forecast.

In an engagement to examine prospective financial information, the auditor1 should obtain sufficient appropriate evidence as to whether:

(a) management's best-estimate assumptions on which the prospective financial information is based are not unreasonable and, in the case of hypothetical assumptions, such assumptions are consistent with the purpose of the information;

(b) the prospective financial information is properly prepared on the basis of the assumptions;

(c) the prospective financial information is properly presented and all material assumptions are adequately disclosed, including a clear indication as to whether they are best-estimate assumptions or hypothetical assumptions; and

(d) the prospective financial information is prepared on a consistent basis with historical financial statements, using appropriate accounting principles.

The auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

This SAE is effective in relation to reports on projections/forecasts, issued on or after April 1, 2007.

1.1.42 SAE 3402- Assurance Reports on Controls at a Service Organisation : This Standard on Assurance Engagements (SAE) deals with assurance engagements undertaken by a professional accountant in public practice to provide a report for use by user entities and their auditors on the controls at a service organization that provides a service to user entities that is likely to be relevant to user entities' internal control as it relates to financial reporting. It complements SA 402, in that reports prepared in accordance with this SAE are capable of providing appropriate evidence under SA 402.

This SAE only deals with assertion-based engagements that convey reasonable assurance, with the assurance conclusion worded directly in terms of the subject matter and the criteria.

This SAE applies only when the service organization is responsible for, or otherwise able to make an assertion about, the suitable design of controls.

This SAE is effective for service auditors' assurance reports covering periods ending on or after April 1, 2011.

1.1.43 SRS 4400: Engagements to Perform Agreed-upon Procedures regarding Financial Information - The purpose of this Standard on Related Services is to establish standards and provide guidance on the auditor's professional responsibilities when an engagement to perform agreed-upon procedures regarding financial information is undertaken and on the form and content of the report that the auditor issues in connection with such an engagement.

[1] The term "auditor" is used throughout this SAE when describing services involving examination of prospective financial information. Such reference is not intended to imply that a member performing such services need necessarily be the statutory auditor of the entity's financial statements.

The objective of an agreed-upon procedures engagement is for the auditor to carry-out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.

The auditor should ensure with representatives of the entity and, ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed procedures and the conditions of the engagement.

The auditor should carry out the procedures agreed-upon and use the evidence obtained as the basis for the report of factual findings.

The procedures applied in an engagement to perform agreed-upon procedures may include:

- *Inquiry and analysis*
- *Recomputation, Comparison and other clerical accuracy checks*
- *Observation*
- *Inspection*
- *Obtaining confirmations*

The report on an agreed-upon procedures engagement needs to describe the purpose and the agreed-upon procedure of the engagement in sufficient detail to enable the reader to understand the nature and the extent of the work performed. The report should also clearly mention that no audit or review has been performed.

This Standard on Related Services is applicable to all agreed-upon procedures engagements beginning on or after April 1, 2004.

1.1.44 SRS 4410: Engagements to Compile Financial Information - The purpose of this Standard on Related Services (SRS) is to establish Standards on professional responsibilities of an accountant when an engagement to compile financial statements or other financial information is undertaken and the form and content of the report to be issued in connection with such a compilation so that the association of the name of the accountant with such financial statements or financial information is not misconstrued by a user of those statements or information as having been audited by him.

In all circumstances when an accountant's name is associated with financial information compiled by him, the accountant should issue a report.

The accountant should obtain an acknowledgement from management of it responsibility for the accuracy and completeness of the underlying accounting data and the complete disclosure of all material and relevant information.

It is in the interest of both the accountant and the entity that the accountant sends an engagement letter documenting the key terms of appointment. An engagement letter confirms the accountant's acceptance of the engagement and helps avoid misunderstanding regarding matters such as the objective and scope of the engagement and the extent of auditors responsibilities.

The accountant should read the complied information and consider whether it appears to be appropriate in form and free from obvious material misstatements.

If the accountant becomes aware of material non-compliance with any applicable Accounting Standard (s), the same should be brought to the attention of management and, if the same is not rectified by the management, it should be included in the Notes to Accounts and the compilation report of the accountant.

The financial statements on other financial information compiled should be approved by the client before the compilation report is signed by the accountant.

This Standard on Related Services (SRS) is applicable to all compilation engagements beginning on or after April 1, 2004.

(Note: Till the time Statements, Engagement and Quality Control Standards, Guidance Notes etc. bare document gets updated from Auditing and Assurance Standard Board of ICAI in pursuance of the Companies Act, 2013, students are required to understand the basic nature of the provision and quote the same along with the new corresponding provisions. Further, students may note that the Framework of Standards, Engagement and Quality Control Standards and Guidance Notes on Related Services are reproduced in Auditing Pronouncements)

Question 1

"The auditors need not review accounting policies unless there is a change in the basis of accounting". Comment.

Answer

The auditor while conducting an audit should critically examine the accounting policies adopted by the client and test them for conformity with the accounting standards and recommendations of the Institute. The Companies Act as well as many other statutes require that the financial statements of an enterprise should give a true and fair view of its financial position and working results. This requirement is implicit even in the absence of a specific statutory provision to this effect. However, what constitutes a 'true and fair' view has not been defined either in the Companies Act or in any other statute. The pronouncements of the Institute seek to describe the accounting principles and the methods of applying these principles in the preparation and presentation of financial statements so that they give a true and fair view. The 'Preface to the Statements of Accounting Standards' issued by the Institute in 1979 states as under:

"While discharging their attest function, it will be the duty of the members of the Institute to ensure that the Accounting Standards are implemented in the presentation of financial statements covered by their audit reports. In the event of any deviation from the Standards, it will be also their duty to make adequate disclosures in their reports so that the users of such statements may be aware of such deviations."

In cases where no pronouncement of the Institute exists, the auditor should examine the acceptability of the said accounting policy. The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the

accounting policies followed in the preparation and presentation of the financial statements. The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated. It is also quite clear that there is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgement by the management of the enterprise. The auditor is further required to determine whether the relevant information is properly disclosed in the financial statements by considering the judgements that management has made in preparing the financial statements; accordingly, the auditor assesses the selection and consistent application of accounting policies, the manner in which the information has been classified, and the adequacy of disclosure.

Thus, the auditor should determine himself as to whether or not the said treatment is consistent with the basic principles of accounting. Therefore, it would not be correct to state that the auditor need not review the accounting policies unless there is a change in the basis of accounting.

Question 2

Briefly describe the auditor's responsibility regarding subsequent events.

Answer

Subsequent Events and Auditor's Responsibility: When the auditor draws up his audit plan, checking of subsequent events is an important audit procedure irrespective of the level of test checks employed for checking of the transactions during the year. In fact more detailed check is normally required for subsequent events to confirm certain assertions contained in the financial statements, e.g., the payment made by debtors after the close of accounting period would confirm that outstanding debtors on the date of the balance sheet date have been realised. SA 560 on "Subsequent Events" establishes standards on the auditor's responsibility regarding subsequent events. SA 560 on "Subsequent Events" states that the term "subsequent events" refers to events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.. AS 4 on " Contingencies and Events Occurring after the Balance Sheet Date" deals with all those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company and by the corresponding approving authority in the case of any other entity. As per AS 4, two types of events can be identified:(a) those which provide further evidence of conditions that existed at the balance sheet date; and (b) those which are indicative of conditions that arose subsequent to the balance sheet date. SA 560 lays down that the auditor should consider the effect of subsequent events on the financial statements and on the auditor's report. When the time between the close of the year-end and the adoption of accounts is about to take place, examination of subsequent events gains more importance.

SA 560 further requires that the auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following:

(a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

(c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(d) Reading the entity's latest subsequent interim financial statements, if any.

When, as a result of the procedures performed above, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.

Question 3

Write short notes on the following:

(a) Financial indications to be considered for evaluating the assumption of going concern

(b) Auditor's responsibilities regarding comparatives.

(c) Sampling Risk

(d) Reporting on a compilation engagements

Answer

(a) Financial Indications and Going Concern: SA 570 on "Going Concern," aims to establish standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the preparation of the financial statements. The following are the financial indications be considered:

- Net liability or net current liability position.

- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by trade payables.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay trade payables on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

(b) Auditor's responsibilities regarding comparatives: SA 710, "Comparative Information – Corresponding Figures and Comparative Financial Statements", establishes standards on the auditor's responsibilities regarding comparatives.

The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

(i) The comparative information agrees with the amounts and other disclosures presented in the prior period; and

(ii) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of SA 560 (Revised).

As required by SA 580 (Revised), the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year's statement of profit and loss.

(c) Sampling Risk: As per SA 530 "Audit Sampling", 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 a test 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 a test of controls, that controls are less effective than they actually are, or in the case of a test 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.

(d) Reporting on a compilation engagements: SA 4410 "Engagements to Compile Financial Information", the report on compilation engagements should, ordinarily, be in the following lay out:

(i) *Title*: The title of the report should be "Accountant's Report on Compilation of Unaudited Financial Statements" (and not "Auditor's Report");

(ii) *Addressee*: The report should ordinarily be addressed to the appointing authority;

(iii) Identification of the financial information also noting that it is based on the information provided by the management;

(iv) When relevant, a statement that the accountant is not independent of the entity;

(v) A statement that the management is responsible for:

- ♦ completeness and accuracy of the underlying data and complete disclosure of all material and relevant information to the accountant;
- ♦ maintaining adequate accounting and other records and internal controls and selecting and applying appropriate accounting policies;
- ♦ preparation and presentation of financial statements or other financial information in accordance with the applicable laws and regulations, if any;
- ♦ establishing controls to safeguard the assets of the entity and preventing and detecting frauds or other irregularities;
- ♦ establishing controls for ensuring that the activities of the entity are carried out in accordance with the applicable laws and regulations and preventing and detecting any non-compliance;

(vi) A statement that the engagement was performed in accordance with this Standard on Related Services;

(vii) A statement that neither an audit nor a review has been carried out and that accordingly no assurance is expressed on the financial information;

(viii) A paragraph, when considered necessary, drawing attention to the disclosure of material departures from the identified financial reporting framework;

(ix) Date of the report;

(x) Place of signature; and

(xi) Accountant's signature

The financial statements or other financial information compiled by the accountant should contain a reference such as "Unaudited," "Compiled without Audit or Review" and also "Refer to Compilation Report" on each page of the financial information or on the front of the complete set of financial statements.

Question 4

Explain what is meant by "Written Representations" and indicate to what extent an auditor can place reliance on such representations.

Answer

Written Representation: A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Thus written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement. Other SAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations. The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report. The written representations shall be in the form of a representation letter addressed to the auditor. If law or regulation requires management to make written public statements about its responsibilities, and the auditor determines that such statements provide some or all of the representations, the relevant matters covered by such statements need not be included in the representation letter.

Extent of Reliance: SA 580, "Written Representations", states that If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general.

In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general. If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

Question 5

"There should be sufficient liaison between a principal auditor and other auditors". Discuss the above statement and state in this context the reporting considerations, when the auditor uses the work performed by other auditor.

Answer

SA 600 on "Using the Work of Another Auditor" lays down the procedure to be applied in situations where a principal auditor reporting on the financial statement of the entity uses the work of another independent auditor. SA 600 contemplates coordination between auditors and requires that there should be sufficient liaison between the principal auditor and the other auditor. For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor. For example, by bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements. Similarly, the principal auditor should advise the other auditor

of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

When considered necessary by him, the principal auditor may require the other auditor to answer a detailed questionnaire regarding matters on which the principal auditor requires information for discharging his duties. The other auditor should respond to such questionnaire on a timely basis.

When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.

In all circumstances, if the other auditor issues, or intends to issue, a modified auditor's report, the principal auditor should consider whether the subject of the modification is of such nature and significance, in relation to the financial information of the entity on which the principal auditor is reporting that it requires a modification of the principal auditor's report.

Question 6

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

(a) While commencing the statutory audit of B Company Limited, the auditor undertook the risk assessment and found that the detection risk relating to certain class of transactions cannot be reduced to acceptance level.

(b) While auditing accounts of a public limited company for the year ended 31st March 2014, an auditor found out an error in the valuation of inventory, which affects the financial statement materially – Comment as per standards on auditing.

Answer

(a) Assessment of Risk and Acceptable Level: 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) Errors in Valuation of Inventories and Auditor's Responsibilities: SA 240, "The Auditor's Responsibilities Relating 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 Materiality in Planning and Performing an Audit, 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.

Question 7

Enumerate the 'Basic Elements of Audit Report' as enshrined in SA 700.

Answer

Basic Elements of Auditor's Report: As per SA 700, "Forming an Opinion and Reporting on Financial Statements", the auditor's report includes the following basic elements:

(a) A title;

(b) An addressee, as required by the circumstances of the engagement;

(c) An introductory paragraph that identifies the financial statements audited;

(d) A description of the responsibility of management (or other appropriate term) for the preparation of the financial statements;

(e) A description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit, that includes:

- A reference to Standards on Auditing and the law or regulation; and

- A description of an audit in accordance with those Standards;

(f) An opinion paragraph containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements (including identifying the jurisdiction of origin of the financial reporting framework);

(g) The auditor's signature;

(h) The date of the auditor's report; and

(i) The place of signature.

Auditor's Report for Audits Conducted in Accordance with Both Auditing Standards issued by the Institute of Chartered Accountants of India and International Standards on Auditing.

Question 8

Write a short note on Responsibility of Joint Auditors.

Answer

Responsibility of Joint Auditors: SA 299 on, "Responsibility of Joint Auditors" deals with the professional responsibilities, which the auditors undertake in accepting such appointments as joint auditors. The responsibilities of joint auditors, as a rule are no different from the responsibilities of individual auditors as enumerated in the Companies Act, 2013. Main features of the said SA are discussed below:

- ***Division of Work****:* Where joint auditors are appointed, they should, by mutual discussion, divide the audit of identifiable units or specified areas. Certain areas of work, owing to their importance or owing to the nature of work involved would not be divided and would be covered by all the joint auditors. Such a division affected by the joint auditors should be adequately documented and preferably communicated to the auditee.
- ***Coordination****:* Where in the course of his work, a joint auditor comes across matters which are relevant to the areas of other joint auditors and which require joint discussion, he should communicate the same to all the other joint auditors in writing before the finalisation of audit and preparation of audit report.

In respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

(a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them.

(b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.

(c) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors.

(d) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute.

(e) for ensuring that the audit report complies with the requirements of the relevant statute.

(f) it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit.

(g) the responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors.

(h) each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

Normally, the joint auditors are able to arrive at an agreed report. However where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

Question 9

(a) G Ltd. is a mobile phone operating company. Barring the marketing function it had outsourced the entire operations like maintenance of mobile infrastructure, customer billing, payroll, accounting functions, etc. Assist the auditor of G Ltd. as to how he can obtain an understanding of how G Ltd. uses the services of the outsourced agency in its operations.

(b) M/s Honest Limited has entered into a transaction on 5th March, 2014, near year-end, whereby it has agreed to pay ₹ 5 lakhs per month to Mr. Y as annual retainer-ship fee for "engineering consultation". No amount was actually paid, but ₹ 60 lakhs is provided in books of account as on March 31, 2014.

Your inquiry elicits a response that need-based consultation was obtained round the year, but there is no documentary or other evidence of receipt of the service. As the auditor of M/s Honest Limited, what would be your approach?

Answer

(a) As per **SA 402 on "Audit Considerations Relating to an Entity Using a Service Organisation"**, when obtaining an understanding of the user entity in accordance with SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including:

(i) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control;

(ii) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;

(iii) The degree of interaction between the activities of the service organisation and those of the user entity; and

(iv) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation.

(b) As per **SA 240 on "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"**, fraud can be committed by management overriding controls using such techniques as Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.

Keeping in view the above, it is clear that Company has passed fictitious journal entries near year end to manipulate the operating results. Also Auditor's enquiry elicited a response that need-based consultation was obtained round the year, but there is no documentary or other evidence of receipt of the service, is not acceptable.

Accordingly, the auditor would adopt the following approach-

If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

(i) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(ii) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(iii) If the auditor withdraws:

(1) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(2) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 10

(a) C & Co., hired Mr. A, Chartered Accountant, to compile its financial statements for the interim period ending on 31st December 2014. Kindly assist Mr. A in drafting scope of engagement letter with specific focus on C & Co's responsibility.

(b) Mr. X was appointed as the auditor of M/s Easygo Ltd. and intends to apply the concept of materiality for the financial statements as a whole. Please guide him as to the factors that may affect the identification of an appropriate benchmark for this purpose.

Answer

(a) As per **SRS 4410 "Engagements to Compile Financial Information"**, the engagement letter to be issued by Mr. A should state the following as management's responsibility:

(i) the accuracy and completeness of the information supplied to us, including maintenance of adequate accounting records and internal controls and selection and application of appropriate accounting policies.

(ii) preparation and presentation of the financial statements of the entity, in accordance with the applicable laws and regulations, if any.

(iii) safeguarding the assets of the entity and also establishing appropriate controls designed to prevent and detect fraud and other irregularities.

(iv) ensuring that the activities of the entity are carried in accordance with applicable laws and regulations and that it institutes appropriate controls to prevent and detect any non-compliance.

(v) Ensuring complete disclosure of all material and relevant information to the accountant.

(b) **SA 320 "Materiality in Planning and Performing an Audit"** prescribes the use of Benchmarks in Determining Materiality for the Financial Statements as a Whole.

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

(i) The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);

(ii) Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);

(iii) The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;

(iv) The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and

(v) The relative volatility of the benchmark.

Question 11

(a) In the course of audit of Z Ltd, its auditor wants to rely on audit evidence obtained in previous audit in respect of effectiveness of internal controls instead of retesting the same during the current audit. As an advisor to the auditor kindly caution him about the factors that may warrant a re-test of controls.

(b) In audit plan for T Ltd, as the audit partner you want to highlight the sources of misstatements, arising from other than fraud, to your audit team and caution them. Identify the sources of misstatements.

(c) The auditor of H Ltd. wanted to obtain confirmation from its trade payables. But the management made a request to the auditor not to seek confirmation from certain trade payables citing disputes. Can the auditor of H Ltd. accede to this request?

(d) R & Co, a firm of Chartered Accountants have not revised the terms of engagements and obtained confirmation from the clients, for last 5 years despite changes in business and professional environment. Please elucidate the circumstances that may warrant the revision in terms of engagement.

Answer

(a) As per **SA 330 on "The Auditor's Responses to Assessed Risks"**, changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance.

The auditor's decision on whether to rely on audit evidence obtained in previous audits for control is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment.

Factors that may warrant a re-test of controls are-

(i) A deficient control environment.

(ii) Deficient monitoring of controls.

(iii) A significant manual element to the relevant controls.

(iv) Personnel changes that significantly affect the application of the control.

(v) Changing circumstances that indicate the need for changes in the control.

(vi) Deficient general IT-controls.

(b) According to **SA 450 "Evaluation of Misstatements identified during the Audit"**, the following are the sources of misstatements arising from other than fraud -

(i) An inaccuracy in gathering or processing data from which the financial statements are prepared;

(ii) An omission of an amount or disclosure;

(iii) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of facts; and

(iv) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

(c) **SA 505, "External Confirmations"**, establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. It requires that the auditor should employ external confirmation procedures in consultation with the management. The auditor may come across certain situations in which the management may request him not to seek external confirmation from certain parties because of dispute with the trade payables, etc. The management, for example, might make such a request on the grounds that due to a dispute with the particular trade payable, the request for confirmation might aggravate the sensitive negotiations between the entity and the trade payables.

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

If the auditor of H Ltd. agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should document the reasons for acceding to the management's request and should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter. While considering the validity of request, in case the auditor of H Ltd. reaches at a conclusion that the same was not valid, he may appropriately modify the report.

(d) As per **SA 210 on "Agreeing the Terms of Audit Engagements"**, the auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

(i) Any indication that the entity misunderstands the objective and scope of the audit.

(ii) Any revised or special terms of the audit engagement.

(iii) A recent change of senior management.

(iv) A significant change in ownership.

(v) A significant change in nature or size of the entity's business.

(vi) A change in legal or regulatory requirements.

(vii) A change in the financial reporting framework adopted in the preparation of the financial statements.

(viii) A change in other reporting requirements.

Question 12

Write short notes on Corresponding figures.

Answer

Corresponding Figures: As per SA 710 "Comparative Information—Corresponding Figures and Comparative Financial Statements", "corresponding figures" is a comparative information where amounts and other disclosures for the preceding period are included as part of the current period financial statements, and are intended to be read in relation to the amounts and other disclosures relating to the current period. These corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period financial statements intended to be read only in relationship to the current period figures.

Question 13

As a statutory auditor of a company, comment on the following:

(a) A fire broke out on 15th May, 2013, in which material worth ₹ 50 lakhs which was lying in inventory since 1st March, 2013 was totally destroyed. The financial statements of the company have not been adopted till the date of fire. The management of the company argues that since the loss occurred in the year, 2013-14, no provision for the loss needs to be made in the financial statements for 2012-13.

(b) While verifying the employee records in a company, it was found that a major portion of the labour employed was child labour. On questioning the management, the auditor was told that it was outside his scope of the financial audit to look into the compliance with other laws.

Answer

(a) Event occurring after the balance sheet date: This case requires attention to SA 560 "Subsequent Events" and AS 4 "Contingencies and Events occurring after the Balance Sheet Date".

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 or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.

AS 4 also requires disclosure of the non-adjusting event, in the report of the approving authority.

Further, 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.

The event took place after the close of the accounting year and does not relate to conditions existing at the balance sheet date. Thus, it will have no effect on items appearing at the balance sheet date because as per AS 4 "Contingencies and Events Occurring after Balance Sheet Date" have to be adjusted that provide evidence of conditions existing as at the balance sheet date. However, the auditor has to ensure that this loss will not materially affect the substratum of the enterprises as per its size, nature and complexity of operations.

Thus, subject to satisfaction in respect of non-violation of going concern concept, the company has correctly accounted by not providing provision. However, the auditor is required to ensure the proper disclosure of abovementioned event.

(b) Compliance with Other Laws: As per SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", the auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements including tax and labour laws.

Further, non-compliance with other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements.

In the instant case, major portion of the labour employed in the company was child labour. While questioning by auditor, reply of the management that it was outside his scope of financial audit to look into the compliance with other laws is not acceptable as it may have a material effect on financial statements.

Thus, auditor should ensure the disclosure of above fact and provision for the cost of fines, litigation or other consequences for the entity. In case if the auditor concludes that non-compliance has a material effect on the financial statements and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statement.

Question 14

While carrying out the statutory audit of a large entity, what are the substantive procedures to be performed to assess the risk of material misstatement?

Answer

Substantive Procedures to be performed to assess the risk of material misstatement: As per SA 330, "The Auditor's Response to Assessed Risk", substantive procedure is an audit procedure designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures.

Test of Details: The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size.

Substantive Analytical Procedure: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

Alternative Solution:

SA 330 'The Auditor's Responses to Assessed Risks' requires the auditor to design and perform substantive procedures for each material class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement.

This requirement reflects the facts that:

- The auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and;
- There are inherent limitations to internal control, including management override.

Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient to reduce the audit risk to an acceptably low level;
- Only tests of detail are appropriate;
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

Based on the above, the auditor's substantive procedures would include the following audit procedures related to the financial statement closing process:

- Agreeing or reconciling the financial statements with the underlying accounting records and
- Examining material journal entries and other adjustments made during the course of preparing the financial statements.

Question 15

(a) ABC Company files a law suit against Unlucky Company for ₹ 5 crores. The Attorney of Unlucky Company feels that the suit is without merit, so Unlucky Company merely discloses the existence of the law suit in the notes accompanying its financial statements. As an auditor of Unlucky Company, how will you deal with the situation?

(b) T & Co. wants to issue a prospectus, to provide potential investors with information about future expectations of the Company. You are hired by T & Co. to examine the projected financial statements and give report thereon. What things you will consider before accepting the audit engagement and what audit evidence will be obtained for reporting on projected financial statements?

(c) In the course of audit of K Ltd., its auditor Mr. 'N' observed that there was a special audit conducted at the instance of the management on a possible suspicion of a fraud and requested for a copy of the report to enable him to report on the fraud aspects. Despite many reminders it was not provided. In absence of the special audit report, Mr. 'N' insisted that he be provided with at least a written representation in respect of fraud on/by the company. For this request also, the management remained silent. Please guide Mr. 'N'.

(d) During the course of audit of Star Limited the auditor received some of the confirmation of the balances of trade payables outstanding in the balance sheet

through external confirmation by negative confirmation request. In the list of trade payables, there are number of trade payables of small balances except one, old outstanding of ₹ 15 Lacs, of whom, no confirmation on the credit balance received. Comment with respect to Standard of Auditing.

Answer

(a) As per AS 29 "Provisions, Contingent liabilities and Contingent Assets", a contingent liability is a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

Further, 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 event will occur.

As per SA 570 "Going Concern", there are certain examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy is one of the example of such event.

When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

In the instant case, ABC Company has filed a law suit against Unlucky Company for ₹ 5 crores. Though, the attorney of Unlucky Company feels that the suit is without merit so the company merely discloses the existence of law suit in the notes accompanying its financial statements. But the auditor may evaluate the source data on which basis the opinion is formed. If the auditor finds the uncertainty, he may request the management to adjust the sum of ₹ 5 crore by making provision for expenses as per AS 29. If the management does not accept the request the auditor should qualify the audit report.

(b) Projected Financial Statements: As per SAE 3400, "The Examination of Prospective Financial Information", the answer is divided into two parts i.e. (i) the things to be considered before accepting the engagement and (ii) audit evidence to be obtained for reporting on projected financial statements.

(i) Acceptance of Engagement: As per SAE 3400, "The Examination of Prospective Financial Information", before accepting an engagement to examine prospective financial information, the auditor would consider, amongst other things:

(1) the intended use of the information;

(2) whether the information will be for general or limited distribution;

(3) the nature of the assumptions, that is, whether they are best-estimates or hypothetical assumptions;

(4) the elements to be included in the information; and

(5) the period covered by the information.

Further, the auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

In accordance with SA 210, "Terms of Audit Engagement", it is necessary that the auditor and the client should agree on the terms of the engagement.

(ii) Audit evidence to be obtained for Reporting on Projected Financial Statements: The auditor should document matters, which are important in providing evidence to support his report on examination of prospective financial information, and evidence that such examination was carried out.

The audit evidence in form of working papers will include:

(1) the sources of information,

(2) basis of forecasts and

(3) the assumptions made in arriving the forecasts,

(4) hypothetical assumptions, evidence supporting the assumptions,

(5) management representations regarding the intended use and distribution of the information, completeness of material assumptions,

(6) management's acceptance of its responsibility for the information,

(7) audit plan,

(8) the nature, timing and extent of examination procedures performed, and,

(9) in case the auditor expresses a modified opinion or withdraws from the engagement, the reasons forming the basis of such decision.

(c) Auditors Responsibilities Relating to Fraud: As per SA 240, "The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements", the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. In addition an auditor conducting an

audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor.

As per SA 580, "Written Representations", if management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist. Further, If management does not provide one or more of the requested written representations, the auditor shall discuss the matter with management; re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

The auditor shall disclaim an opinion on the financial statements if the auditor concludes that there is sufficient doubt about the integrity of management such that the written representations are not reliable; or management does not provide the written representations.

In the instant case, in the course of audit of K Ltd., its auditor Mr. N observed that there was a special audit conducted at the instance of the management on a possible suspicion of fraud. Therefore, the auditor requested for special audit report, which was not provided by the management despite of many reminders. Mr. N also insisted for written representation in respect of fraud on/by the company. For this request also management remained silent.

Hence, the fact is required to be reported and the auditor should also disclaim an opinion on the financial statements.

d) External Confirmation: As per SA 505, "External Confirmation", Negative Confirmation is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative confirmations provide less persuasive audit evidence than positive confirmations.

The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request. Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favor, and less likely to respond otherwise.

In the instant case, the auditor sent the negative confirmation requesting the trade payables having outstanding balances in the balance sheet while doing audit of Star Limited. One of the old outstanding of rupees 15 lacs has not sent the confirmation on the credit balance. In case of non response, the auditor may examine subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes. Further non response for negative confirmation request does not means that there is some misstatement as negative confirmation request itself is to respond to the auditor only if the confirming party disagrees with the information provided in the request.

But, if the auditor identifies factors that give rise to doubts about the reliability of the response to the confirmation request, he shall obtain further audit evidence to resolve those doubts.

Question 16

Elaborate how the Statutory Auditor can verify the existence of related parties for the purpose of reporting under Accounting Standard 18.

Answer

Verification of Existence of Related Parties: As per SA 550 "Related Parties", during the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. Example-

(i) Entity Income Tax Returns.

(ii) Information supplied by the entity to regulatory authorities.

(iii) Shareholder registers to identify the entity's principal shareholders.

(iv) Statements of conflicts of interest from management and those charged with governance.

(v) Records of the entity's investments and those of its pension plans.

(vi) Contracts and agreements with key management or those charged with governance.

(vii) Significant contracts and agreements not in the entity's ordinary course of business.

(viii) Specific invoices and correspondence from the entity's professional advisors.

(ix) Life insurance policies acquired by the entity.

(x) Significant contracts re-negotiated by the entity during the period.

(xi) Internal auditors' reports.

(xii) Documents associated with the entity's filings with a securities regulator (e.g., prospectuses).

Arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions.

In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

(i) Bank, legal and third party confirmations obtained as part of the auditor's procedures;

(ii) Minutes of meetings of shareholders and of those charged with governance; and

(iii) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

Question 17

(a) R & Co. is the statutory auditor of S Ltd. For the financial year ended on 31st March 2014, S Ltd had disclosed in the notes (Note No. X) "The state pollution control board had ordered the closure of the company's only manufacturing plant on the ground that it is environmentally damaging, which the company had challenged in a law suit. Pending the outcome of the law suit the financial statements are prepared on a going concern basis". Further the financial statements prepared by the management of S Ltd include financial statements of certain branches which are audited by other auditors. What are the reporting responsibilities of R & Co.?

(b) In the course of the statutory audit of Z Ltd, its statutory auditors, having determined that the work of internal auditor is likely to be adequate for the purpose of statutory audit, wanted to use the work of internal auditor in respect of physical verification of fixed assets. How an evaluation of this specific work done by the internal auditor can be done?

Answer

(a) Reporting Responsibilities of Statutory Auditor: This question involves two broad aspect with respect to reporting requirements i.e. (i) one which deals with Going Concern aspect where the company has gone for legal suit and (ii) other is work done by other auditors.

As per facts of the case, the State Pollution Control Board has issued the closure order for S Ltd., on account of environmental damaging by its only manufacturing plant. However, S Ltd had challenged the same by way of a law suit. Due to pendency of the outcome of the legal suit, the company has prepared its financial statements on going concern basis.

As per SA 570 "Going Concern", under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions.

The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. For this the auditor may take the help of expert.

As per SA 620, "Using the Work of an Auditor's Expert", if expertise in a field is necessary to obtain sufficient appropriate audit evidence, he may determine to use the work of an auditor's expert. On the basis of expert's opinion he may decide to rely or not on assessment of management.

As per SA 570 "Going Concern", pending legal proceedings is a condition that, individually, may cast significant doubt about the going concern assumption. Existence of above condition signifies that a material uncertainty exists.

Further, when the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

(i) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(ii) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph as per SA 706 "Emphasis of matter paragraphs and other matter paragraphs in the Independent Auditor's Report", in the auditor's report to:

(a) Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and

(b) Draw attention to the note in the financial statements that discloses the matters

In the present situation, management of S Ltd. had disclosed the above fact in the financial statement. Further, use of the going concern assumption is appropriate but a material uncertainty exists so assuming the assessment and disclosure of S Ltd. in order, R & Co. should include an Emphasis of Matter paragraph in the auditor's report.

Further, as per SA 600 "Using the work of Another Auditor", when the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon

the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/ branches/ subsidiaries or other components audited by other auditors.

Note: Alternative answer is possible assuming that company is not going concern, hence auditor should issue adverse report.

(b) Evaluation of Specific Work Done by Internal Auditor: The statutory auditor should as a part of his audit, carryout general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor.

As per SA 610 "Using the Work of Internal Auditors", the nature, timing and extent of the audit procedures performed on specific work of the internal auditors will depend on the external auditor's assessment of the risk of material misstatement, the evaluation of the internal audit function, and the evaluation of the specific work of the internal auditors. Such audit procedures may include examination of items already examined by the internal auditors, examination of other similar items; and observation of procedures performed by the internal auditors.

Further, to determine the adequacy of specific work performed by the internal auditors for the external auditor's purposes, the external auditor shall evaluate whether:

(i) The work was performed by internal auditors having adequate technical training and proficiency;

(ii) The work was properly supervised, reviewed and documented;

(iii) Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;

(iv) 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

(v) Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

Question 18

In the course of audit of Q Ltd, its statutory auditor wants to be sure of the adequacy of related party disclosures? Kindly guide the auditor in identifying the possible source of related party information.

Answer

Identification of possible sources for Related Parties' information: As per SA 550 on, "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties. However, it is the management, which is primarily responsible for identification of related parties. The duties of an auditor with regard to reporting of related party transaction as required by Accounting Standard 18 "Related Party Disclosures" is given in SA 550.

(i) SA 550 requires that to identify names of all known related parties, the auditor may inspect records or documents that may provide information about related party relationships and transactions, for example entity income tax returns, information supplied by the entity to regulatory authorities, shareholder registers to identify the entity's principal shareholders, statements of conflicts of interest from management and those charged with governance, records of the entity's investments and those of its pension plans, contracts and agreements with key management or those charged with governance, significant contracts and agreements not in the entity's ordinary course of business, specific invoices and correspondence from the entity's professional advisors, life insurance policies acquired by the entity, significant contracts re-negotiated by the entity during the period, internal auditors' reports, documents associated with the entity's filings with a securities regulator (e.g., prospectuses).

(ii) Some arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions as an arrangement involves a formal or informal agreement between the entity and one or more other parties for such purposes as the establishment of a business relationship through appropriate vehicles or structures, the conduct of certain types of transactions under specific terms and conditions or the provision of designated services or financial support.

Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor include participation in unincorporated partnerships with other parties, agreements for the provision of services to certain parties under terms and conditions that are outside the entity's normal course of business, guarantees and guarantor relationships etc.

(iii) Obtaining further information on significant transactions outside the entity's normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and, where the applicable financial reporting framework establishes related party requirements, to identify the risks of material misstatement. In addition, the auditor needs to be alert for transactions which appear unusual in the circumstances and which may indicate the existence of previously unidentified related parties. Examples of transactions outside the entity's normal course of business may include complex equity transactions, such as corporate restructurings or acquisitions, transactions with offshore entities in jurisdictions with weak corporate laws, the leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged, sales transactions with unusually large discounts or returns, transactions with circular arrangements, for example, sales with a commitment to repurchase, transactions under contracts whose terms are changed before expiry etc.

(iv) Finally, the auditor should also obtain a written representation from the management concerning the completeness of information provided regarding the identification of related parties.

Question 19

In the course of audit of A Ltd you suspect the management has indulged in fraudulent financial reporting? State the possible source of such fraudulent financial reporting.

Answer

Possible Sources of Fraudulent Financial Reporting: As per SA 240, "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements", fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. It may be accomplished by manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared or Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information or intentional misstatements involve intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure etc.

It often involves management override of controls, misappropriation of assets etc that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

(i) Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.

(ii) Inappropriately adjusting assumptions and changing judgments used to estimate account balances.

(iii) Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.

(iv) Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.

(v) Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.

(vi) Altering records and terms related to significant and unusual transactions.

(vii) Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).

(viii) Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).

(ix) Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).

(x) Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 20

The auditor of SS Ltd. accepted the gratuity liability valuation based on the certificate issued by a qualified actuary. However, the auditor noticed that the retirement age adopted is 65 years as against the existing retirement age of 60 years. The company is considering a proposal to increase the retirement age. Comment.

Answer

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

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

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

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

Question 21

State briefly the basic elements of Management Representation Letter.

Answer

Basic Elements of a Management Representation Letter: As per SA 580 "Written Representations", some of the basic elements of a Management Representation letter are-

(1) It is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence.

(2) It does not include financial statements, the assertions therein, or supporting books and records.

(3) The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement.

(4) The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

Question 22

(a) While auditing Z Ltd., you observe certain material financial statement assertions have been based on estimates made by the management. As the auditor how do you minimize the risk of material misstatements?

(b) The accountant of C Ltd. has requested you, not to send balance confirmations to a particular group of trade receivables since the said balances are under dispute and the matter is pending in the Court. As a Statutory Auditor, how would you deal?

Answer

(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) SA 505 "External Confirmations", establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. If the management refuses to allow the auditor to a send a confirmation request, the auditor shall:

(i) Inquire as to Management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness,

(ii) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures, and

(iii) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those in charge of governance and also determine its implication for the audit and his opinion.

Question 23

Y Ltd. engaged an actuary to ascertain its employee cost, gratuity and leave encashment liabilities. As the auditor of Y Ltd., you would like to use the report of the actuary as an audit evidence. How do you evaluate the work of the actuary?

Answer

Evaluating the work of an Auditor's Expert: As per SA 620 "Using the Work of an Auditor's Expert", when management has used a management's expert in preparing the financial statements, the auditor's decision on whether to use an auditor's expert may also be influenced by such factors as:

(i) The nature, scope and objectives of the management's expert's work.

(ii) Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.

(iii) The extent to which management can exercise control or influence over the work of the management's expert.

(iv) The management's expert's competence and capabilities.

(v) Whether the management's expert is subject to technical performance standards or other professional or industry requirements.

(vi) Any controls within the entity over the management's expert's work.

However, an evaluation of the work of an expert can be done considering the following facts:

(i) When the auditor plans to use the expert's work as audit evidence, he should satisfy himself as to the expert's skills and competence by considering the expert's:

  (1) professional qualifications, license or membership in an appropriate professional body, and

  (2) experience and reputation in the field in which the evidence is sought.

(ii) The objectives and scope of the experts' work.

(iii) A general outline as to specific items in the expert's report.

(iv) Confidentiality of the client's information used by the expert.

(v) The source data used.

(vi) The assumptions and methods used and, if appropriate, their comparison with the prior period.

(vii) The results of the expert's work in the light of auditor's overall knowledge of the business and of the results of his audit procedures.

(viii) The auditor should also satisfy himself that the substance of the expert's findings is properly reflected in the financial statements.

(ix) Consider whether the expert has used the appropriate source data, by making inquiries of the expert.

(x) Conducting audit procedures on the data by the client to the expert to obtain reasonable assurance that the data are appropriate.

Question 24

Write short notes on Frauds through supplier ledger.

Answer

Frauds Committed through Suppliers Ledger: Fraud through supplies ledger could be made in any of the following ways, which the auditor has to take care of:

(i) Inflating suppliers account with fictitious or duplicate invoices and subsequent misappropriations as if payments are made to the supplier

(ii) Suppressing credit notes issued by the suppliers and withdrawing the corresponding amount not claimed by them.

(iii) Withdrawing amounts which remain unclaimed for more than the normal time limit for one reason or other by showing the same have been paid to the parties.

(iv) Inflating values of items purchased and collecting the excess from suppliers i.e. accepting invoices at prices considerably higher than the market price and collecting the excess claim from the suppliers directly.

Question 25

A Co. Ltd. has not included in the Balance Sheet as on 31-03-2014 a sum of ₹ 1.50 crores being amount in the arrears of salaries and wages payable to the staff for the last 2 years as a result of successful negotiations which were going on during the last 18 months and concluded on 30-04-2014. The auditor wants to sign the said Balance Sheet and give the audit report on 31-05-2014. The auditor came to know the result of the negotiations on 15-05-2014. Comment.

Answer

Subsequent Events: 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. 31-3-2014 to the date of Auditors Report ie.31-05-2014. 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 2012-13 and 2013-14 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.

Question 26

While doing audit, Ram, the Auditor requires reports from experts for the purpose of Audit evidence. What types of reports/opinions he can obtain and to what extent he can rely upon the same?

Answer

Using the Work of an Auditor's Expert: As per SA 620, "Using the Work of an Auditor's Expert", during the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert.

While doing audit, Ram, the auditor can obtain the following types of reports, or options or statements of an expert for the purpose of audit evidence:

(i) The valuation of complex financial instruments, land and buildings, plant and machinery, jewelry, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.

(ii) The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.

(iii) The estimation of oil and gas reserves.

(iv) The valuation of environmental liabilities, and site clean-up costs.

(v) The interpretation of contracts, laws and regulations.

(vi) The analysis of complex or unusual tax compliance issues.

When the auditor intends to use the work of an expert, he shall evaluate the adequacy of the auditor's expert's work, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence; if that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and if that expert's work involves the use of source data that is significant to his work, the relevance, completeness, and accuracy of that source data.

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, he shall agree with that expert on the nature and extent of further work to be performed by that expert; or perform further audit procedures appropriate to the circumstances.

Question 27

S Ltd. issued Bonds to the tune of ₹ 100 lacs and provided security to the tune of ₹ 80 lacs for the same. It insists that it will disclose the Bonds as "Secured" in the Balance Sheet of the Company. Comment.

Answer

Disclosure in Balance Sheet: Prima facie, the Bonds issued to the tune of ₹ 100 lacs are provided with security to the tune of ₹ 80 lacs i.e. neither fully secured nor unsecured. Guidance Note on the "Terms used in Financial Statements" issued by ICAI, states "Secured Loans" as loan secured wholly or partly against an asset. Hence the Bonds should be classified under 'Secured Loans' for the purpose of disclosure in the Balance Sheet. However the nature of security should be clearly specified.

Question 28

(a) In the course of audit of ABC Ltd. its management refuses to provide written representations. As an auditor what is your duty?

(b) While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?

(c) What are the auditor's responsibilities in respect of corresponding figures?

(d) IT systems also pose specific risks to an entity's internal control? What are those risks?

Answer

(a) Duty of an Auditor if management refuses to provide written representations: As per SA 580 "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 in accordance with SA 705 "Modifications to the Opinion in the Independent Auditor's Report".

(b) Risk Factors while applying sampling techniques: As per SA 530 "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 exists 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 misstatements 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.

(c) Auditor's responsibilities in respect of corresponding figures: As per SA 710 "Comparative Information—Corresponding Figures and Comparative Financial Statements", in respect of corresponding figures, the auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

(a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and

(b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of SA 560 "Subsequent Events".

As required by SA 580, "Written Representations", the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year's statement of profit and loss.

(d) Specific Risk to an Entity's internal Control: As per SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", IT system also poses specific risks to an entity's Internal Control. They are–

(i) Reliance on systems or programs that are inaccurately processing data, processing inaccurate data or both.

(ii) Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risk may arise when multiple users access a common database.

(iii) The possibility of IT personnel gaining access beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.

(iv) Unauthorised changes to data in Master files.

(v) Unauthorised changes to systems or programs.

(vi) Failure to make necessary changes to systems or programs.

(vii) In appropriate manual intervention.

(viii) Potential loss of data or inability to access data as required.

Question 29

Comment on the following:

(a) 'A' Limited has paid minimum alternate tax under Section 115 JB of the Income Tax Act, 1961, for the year ended 31st March, 2014 The company wants to disclose the same as an 'Asset' since the company is eligible to claim credit for the same.

(b) Moon Limited replaced its statutory auditor for the Financial year 2013-14. During the course of audit, the new auditor found a credit item of ₹ 5 lakhs. On enquiry, the company explained him that it is, a very old credit balance. The trade payable had neither approached for the payment nor he is traceable. Under the circumstances no confirmation of the credit balance is available.

Answer

(a) Disclosure of MAT: As per Para 6 of the Guidance Note issued by ICAI on "Accounting for credit available in respect of MAT under the IT Act, 1961", although MAT credit is not a deferred tax asset under AS 22, yet it gives rise to expected future economic benefit in the form of adjustment of future income tax liability arising within the specific period.

The Framework for the preparation and presentation of financial statements, issued by the ICAI, defines the term 'asset' is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

MAT paid in a year in respect of which the credit is allowed during the specified period under the Income Tax Act is a resource controlled by the company as a result of past event, namely the payment of MAT. The MAT credit has expected future economic benefits in the form of its adjustment against the discharge of the normal tax liability if the same arises during the specified period. Accordingly, such credit is an asset.

According to the Framework, once an item meets the definition of the term 'Asset', it has to meet the criteria for recognition of an asset, so that it may be recognised as such in the financial statements.

Para 88 of the Framework provides the following criteria for recognition of an asset:

An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

Thus, if the auditor is satisfied that the probability of the company to claim the said credit is high, it could recognise the same as an asset. In balance sheet it could be shown under the head "Loans and Advances" as MAT credit entitlement.

(b) External Confirmation: This is a case of external confirmation, covered by SA 505 "External Confirmations". The identities of trade payables are not traceable to confirm the credit balance as appearing in the financial statement of the company. It is also not a case of pending litigation.

It might be a case that an income of ₹5 lakhs had been hidden in previous year/s. The statutory auditor should examine the validity of the credit balance as appeared in the company's financial statements. He should obtain sufficient evidence in support of the balance. He should apply alternative audit procedures to get documentary proof for the transaction/s and should not rely entirely on the management representation. Finally, he should include the matter by way of a qualification in his audit report to the members.

Question 30

Briefly explain Audit procedures on subsequent events.

Answer

Audit Procedures on Subsequent Events: As per SA 560 "Subsequent Events", events occurring between the dates of balance sheet and audit report and the facts that become known to the auditor after the date of the auditor's report.

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following:

(a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

(c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(d) Reading the entity's latest subsequent interim financial statements, if any.

When, as a result of the procedures performed as required the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.

Question 31

Explain briefly duties and responsibilities of an auditor in case of material misstatement resulting from Management Fraud.

Answer

Duties & Responsibilities of an auditor in case of Material misstatement resulting from management fraud: Misstatement in the financial statements can arise from fraud or error. The term fraud refers to an 'Intentional Act' by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. The auditor, conducting an audit, is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

As described in SA 200, the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls

and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

Additionally, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 32

Comment on the following:

(a) You are appointed to compile financial statements of Y & Co. for tax purposes. During the course of work, you learn that the inventory is grossly understated. On pointing the same, the partners of Y & Co. tell you that since you are not conducting an audit, the said figures duly certified by the firm should be accepted.

(b) While conducting statutory Audit of ABC Ltd., you come across IOUs amounting to ₹ 2 crores as against a cash balance shown in books of ₹ 2.10 crores. You also observe that despite similar high balances throughout the year, small amounts of ₹ 50,000 are withdrawn from the bank to meet day-to-day expenses.

(c) Z Ltd. had appointed an outside expert to assess accrued gratuity liability of the company. Based on the said report, the company provides ₹ 80 lakhs as gratuity in the financial statements.

(d) A Company's net worth is eroded and trade payables are unpaid due to liquidity constraints. The management represents to the statutory auditor that the promoter's wife is expected to give an unsecured loan to meet the liquidity constraints and that negotiations are underway to secure large export orders.

Answer

(a) Compilation of Financial Statements: According to SRS 4410 "Engagements 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.

As per guidance note on Tax Audit under section 44AB of the Income Tax Act, 1961, the stock auditor should study the procedure followed by the assessee in taking the inventory of closing stock at the end of the year and the valuation thereof. The tax auditor should also examine the basis adopted for ascertaining the cost and this basis should be consistently followed. It is very necessary for an auditor to ensure that the method followed for valuation of stock results in disclosure of correct profit and gains.

In the instant case, appointment was made to compile financial statements for tax audit purpose of Y & Co., a firm. It is our duty of to ensure that method followed for valuation of stock results in disclosure of correct profit and gains.

In this case the stock valuation was grossly understated. Consequently, disclosure of profit is also not correct. Hence, contention of the Y & Co., that you are not the conducting an audit, the said figures duly certified by the firm should be accepted is not correct.

(b) Material Misstatements: According to SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" when the auditor comes across such circumstances indicating the possible misstatements resulting from the fraud then the auditor needs to consider the impact of fraud on financial statements and its disclosure in the audit report. In this case, the circumstances indicate that the possible misstatement in financial statements is due to fraud and error and the auditor must investigate further to consider effect on financial statements.

The Guidance Note on Audit of Cash and Bank balances also mentions that if the entity is maintaining an unduly large balance of cash, he should carry out surprise verification of cash more frequently to ascertain whether it agrees. If cash in hand is not in agreement with the book balance, he should seek explanations and if the same are not satisfactory should state the said fact appropriately in his Audit Report.

(c) SA 620 "Using the work of an Auditor's Expert" 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) Going Concern Assumption: In this case, it is subjective, but prima-facie a mere expectation of future cash flows from the promoter's wife without any firm commitment and the possibility of an export order being negotiated, may not that be sufficient appropriate audit evidence of mitigating factors for resolving the going concerns question under SA 570 "Going Concern".

Question 33

The audit report of P Ltd. for the year 2012-13 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2013-14, how would you report, if:

(i) The company does not make provision for doubtful debts in 2013-14?

(ii) The company makes adequate provision for doubtful debts in 2013-14?

Answer

Auditor's responsibilities in cases where audit report for an earlier year is qualified is given in SA 710 "Comparative Information – Corresponding Figures and Comparative Financial Statements". As per SA 710, When the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.

SA 710 further states that if the auditor's report on the prior period, as previously issued, included a qualified opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

(i) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or

(ii) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

In the instant Case, if P Ltd. does not make provision for doubtful debts the auditor will have to modify his report for both current and previous year's figures as mentioned above. If however, the provision is made, the auditor need not refer to the earlier year's modification.

Question 34

Comment on the following:

(a) You are the auditor of Easy Communications Ltd. for the year 2013–14. The inventory as at the end of the year i.e. 31.3.14 was ₹ 2.25 crores. Due to unavoideable circumstances, you could not be present at the time of annual physical verification. Under the above circumstances how would you ensure that the physical verification conducted by the management was in order?

(b) You have been appointed as the auditor of Good Health Ltd. for 2013-14 which was audited by CA Trustworthy in 2012-13. As the Auditor of the company state the steps you would take to ensure that the Closing Balances of 2012-13 have been brought to account in 2013-14 as Opening Balances and the Opening Balances do not contain misstatements.

Answer

(a) As per **SA 501 "Audit Evidence – Additional Considerations for Specific Items",** the auditor should perform audit procedures, designed to obtain sufficient appropriate audit evidence during his attendance at physical inventory counting. SA 501 is additional guidance to that contained in SA 500, "Audit Evidence", with respect to certain specific financial statement amounts and other disclosures.

If the auditor is unable to be present at the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded. The auditor would also verify the procedure adopted, treatment given for the discrepancies noticed during the physical count. The auditor would also ensure that appropriate cut off procedures were followed by the management. He should also get management's written representation on (a) the completeness of information provided regarding the inventory, and (b) assurance with regard to adherence to laid down procedures for physical inventory count.

By following the above procedure it will be ensured that the physical verification conducted by the management was in order.

(b) As per **SA 510 "Initial Audit Engagements—Opening Balances"**, in conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

(i) Opening balances contain misstatements that materially affect the current period's financial statements; and

(ii) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Being new assignment audit evidence regarding opening balances can be obtained by perusing the copies of the audited financial statements.

For current assets and liabilities some audit evidence can ordinarily be obtained as part of audit procedures during the current period. For example, the collection/payment of opening balances of receivables and payables will provide audit evidence as to their existence, rights and obligations, completeness and valuation at the beginning of the period.

In respect of other assets and liabilities such as fixed assets, investments long term debt, the auditor will examine the records relating to opening balances. The auditor may also be able to get confirmation from third parties (e.g., balances of long term loan obtained from banks).

Question 35

Write short notes on Situations where external confirmations can be used.

Answer

Situations where external confirmations can be used:

(i) Bank balance from bankers

(ii) Account receivable balances

(iii) Inventories held by third parties

(iv) Property title deeds held by third parties

(v) Investments purchased but delivery not taken

(vi) Loan from lenders

(vii) Account payable balances

(viii) Long outstanding share application money.

Question 36

You notice a misstatement resulting from fraud or suspected fraud during the audit and conclude that it is not possible to continue the performance of audit. As a Statutory Auditor, how would you deal?

Answer

Impossibility to continue the performance of audit: According to SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", if, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(c) If the auditor withdraws:

(i) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 37

"The auditors should communicate audit matters of governance interest arising from the audit of financial statements with those charged with the governance of an entity". Briefly state the matters to be included in such Communication.

Answer

Communications of audit matters with those charged with governance: As per SA 260 "Communication with those Charged with Governance", the auditor shall communicate with those charged with governance, the responsibilities of the auditor in relation to the financial statement audit, including that:

(a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and

(b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

The auditor shall communicate with those charged with governance the following:

(a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

(b) Significant difficulties, if any, encountered during the audit;

(c) Unless all of those charged with governance are involved in managing the entity:

(i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and

(ii) Written representations the auditor is requesting; and

(d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

Question 38

State the reporting responsibility of an auditor in the context of non-compliance of Law and Regulation in an audit of Financial Statement.

Answer

Reporting responsibility of an auditor in the context of non-compliance of Law and Regulation: According to SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statements", the reporting responsibilities of an Auditor may be divided into the following categories-

Reporting Non-Compliance to Those Charged with Governance: Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated by the auditor, the auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

If, in the auditor's judgment, the non-compliance referred above is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.

If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

Reporting Non-Compliance in the Auditor's Report on the Financial Statements: If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with SA 705 express a qualified or adverse opinion on the financial statements.

If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with SA 705.

If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor's opinion in accordance with SA 705.

Reporting Non-Compliance to Regulatory and Enforcement Authorities: If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity.

Question 39

Write a short note on Reporting on a compilation engagements.

Answer

Reporting on a compilation engagements: As per SA 4410 "Engagements to Compile Financial Information", the report on compilation engagements should, ordinarily, be in the following layout:

(a) *Title*: The title of the report should be "Accountant's Report on Compilation of Unaudited Financial Statements" (and not "Auditor's Report");

(b) *Addressee*: The report should ordinarily be addressed to the appointing authority;

(c) Identification of the financial information also noting that it is based on the information provided by the management;

(d) When relevant, a statement that the accountant is not independent of the entity;

(e) A statement that the management is responsible for:

- ♦ completeness and accuracy of the underlying data and complete disclosure of all material and relevant information to the accountant;
- ♦ maintaining adequate accounting and other records and internal controls and selecting and applying appropriate accounting policies;
- ♦ preparation and presentation of financial statements or other financial information in accordance with the applicable laws and regulations, if any;
- ♦ establishing controls to safeguard the assets of the entity and preventing and detecting frauds or other irregularities;
- ♦ establishing controls for ensuring that the activities of the entity are carried out in accordance with the applicable laws and regulations and preventing and detecting any non-compliance;

(f) A statement that the engagement was performed in accordance with this Standard on Related Services;

(g) A statement that neither an audit nor a review has been carried out and that accordingly no assurance is expressed on the financial information;

(h) A paragraph, when considered necessary, drawing attention to the disclosure of material departures from the identified financial reporting framework;

(i) Date of the report;

(j) Place of signature; and

(k) Accountant's signature.

The financial statements or other financial information compiled by the accountant should contain a reference such as "Unaudited," "Compiled without Audit or Review" and also "Refer to Compilation Report" on each page of the financial information or on the front of the complete set of financial statements.

Question 40

A Company gets its accounting data processed by a third party to achieve cost reduction. As a Statutory Auditor of such a company, what are the additional precautions/checks that you would consider for conduct of the audit?

Answer

Precaution to be taken by auditor in case accounting data processed by third party: Processing of accounting data may be given to a third party on account of various considerations such as economy, own computer working to full capacity, an interim measures restricting accessibility to sensitive information, etc. A client may use a service organisation such as one that executes transactions and maintains related accountability or records transactions and processes related data (e.g., a computer systems service organisation). If a client uses a service organisation, certain policies, procedures and records maintained by the service organisation might be relevant to the audit of the financial statements of the client. Consequently, the auditor would consider the nature and extent of activities undertaken by service organisations so as to determine whether those activities are relevant to the audit and, if so, to assess their effect on audit risk.

As per SA 402 "Audit Considerations relating to an Entity using a Service Organization", when obtaining an understanding of the user entity in accordance with SA 315, the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including:

(a) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control;

(b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;

(c) The degree of interaction between the activities of the service organisation and those of the user entity; and

(d) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation.

Information on the nature of the services provided by a service organisation may be available from a wide variety of sources, such as user manuals; system overviews; technical manuals; the contract or service level agreement between the user entity and the service organisation; reports by service organisations, internal auditors or regulatory authorities on controls at the service organisation; reports by the service auditor, including management letters, if available.

Knowledge obtained through the user auditor's experience with the service organisation, for example through experience with other audit engagements, may also be helpful in obtaining an understanding of the nature of the services provided by the service organisation. This may be particularly helpful if the services and controls at the service organisation over those services are highly standardized.

Question 41

Answer the following:

(a) Enumerate (in brief) the basic principles governing an audit.

(b) While examining the going concern assumption of an entity, what important indications should be evaluated and examined?

Answer

(a) Basic Principles Governing an Audit: The basic principles which govern the auditor's professional responsibilities and which should be complied with wherever an audit is carried are described below:

(i) **Integrity, Objectivity and Independence:** The auditor should be straightforward, honest and sincere in his approach to his professional work. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being compatible with integrity and objectivity.

(ii) **Confidentiality:** The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.

(iii) **Skills and Competence:** The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence in auditing. The auditor requires specialised skills and competence along with a continuing awareness of developments including pronouncements of the ICAI on accounting and auditing matters, and relevant regulations and statutory requirements.

(iv) **Work performed by others:** When the auditor delegates work to assistants or uses work performed by other auditor and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied.

(v) **Documentation:** The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.

(vi) **Planning:** The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on a knowledge of the client's business.

(vii) **Audit evidence:** The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.

(viii) **Accounting System and Internal Control:** The auditor should gain an understanding of the accounting system and related controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

(ix) **Audit conclusions and reporting**: The auditor should review and assess the conclusions drawn from the audit evidence obtain and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.

The audit report should contain a clear written opinion on the financial information and should comply the legal requirements. When a qualified opinion, adverse opinion or a disclaimer of opinion is to be given or reservation of opinion on any matter is to be made, the audit report should state the reasons therefore.

(**Note**: Student may note that at present, there is no specific standard namely basic principles governing an audit. However, there are certain fundamental principles which are ethically required as per Code of Ethics read with SA 200 and SA 220. But in general above mentioned principles are basic principles only).

(b) Evaluating Going Concern Assumption: SA 570 "Going Concern", requires that while planning a performing audit procedure and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements. In assessing such a risk, the auditor should examine the following indications-

Financial Indications

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by trade payables.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay trade payables on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating Indications

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labour difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other Indications

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

Question 42

The Managing Director of the Company has committed a "Teeming and Lading" Fraud. The amount involved has been however subsequently after the year end deposited in the company. As a Statutory Auditor, how would you deal?

Answer

Fraud Committed by Managing Director: The Managing Director of the company has committed a "Teeming and Lading" fraud. The fact that the amount involved has been subsequently deposited after the year end is not important because the auditor is required to

perform his responsibilities as laid down in SA 240, "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements". First of all, as per SA 240, the auditor needs to perform procedures whether the financial statements are materially misstated. Because an instance of fraud cannot be considered as an isolated occurrence and it becomes important for the auditor to perform audit procedures and revise the audit risk assessment. Secondly, the auditor needs to consider the impact of fraud on financial statements and its disclosure in the audit report. Thirdly, the auditor should communicate the matter to the Chairman and Board of Directors. Finally, in view of the fact that the fraud has been committed at the highest level of management, it affects the reliability of audit evidence previously obtained since there is a genuine doubt about representations of management.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 43

While compiling the financial statements of a concern, you observed that the input information supplied by the concern is incomplete, incorrect and few of the Accounting Standards have not been followed. Describe, in brief, the procedure you will follow in the above.

Answer

Compilation of Financial Information: According to SRS 4410 "Engagements to Compile Financial Information", an accountant would normally have to rely upon the management for information to compile the financial statements in a compilation engagement. If in the course of compilation of financial statements, it is observed that the information supplied by the entity is incorrect, incomplete or otherwise unsatisfactory, the accountant should perform following procedures:

(i) Make any enquiries of management to assess the reliability and completeness of the information provided;

(ii) Assess internal controls prevailing in the entity; and

(iii) Verify any matters or explanations.

The accountant may also request the management to provide additional information. This may be asked in the form of management representation letter. If the management refuses to provide additional information, the accountant should withdraw from the engagement, informing the entity of the reasons for such withdrawal.

If one or more accounting standards are not complied with, the same should be brought to the notice of the management and if the same is not rectified by the management, the accountant should include the same in notes to the accounts and the compilation report to the management.

Question 44

Obtaining audit evidence in performing compliance and substantive procedures. Comment.

Answer

Obtaining Audit Evidence: As per SA 500 "Audit Evidence", in performing compliance and substantive procedures, the auditor may obtain audit evidence by following methods-

(i) **Inspection:** Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

(ii) **Observation:** Observation consists of looking at a process **or** procedure being performed by the others. For example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

(iii) **External Confirmation:** An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition.

(iv) **Recalculation:** Recalculation consists of checking the arithmetical accuracy of documents or records. Recalculation may be performed manually or electronically.

(v) **Reperformance**: It involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

(vi) **Analytical Procedure**: Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

(vii) **Inquiry:** Inquiry consists of seeking information of knowledgeable persons, both financial and non- financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Question 45

An auditor of Sagar Ltd. was not able to get the confirmation about the existence and value of certain machineries. However, the management gave him a certificate to prove the existence and value of the machinery as appearing in the books of account. The auditor accepted the same without any further procedure and signed the audit report. Is he right in his approach?

Answer

Validity of Management Representation: 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 Sagar 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.

Question 46

(a) What are 'Initial Audit Engagements'?

(b) In an initial audit engagement the auditor will have 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. Lay down the audit procedure, you will follow in cases (i) when the financial statements are audited for the preceding period by another auditor; and (ii) when financial statements are audited for the first time.

(c) If, after performing the procedure, you are not satisfied about the correctness of 'Opening Balances'; what approach you will adopt in drafting your audit report in two situations mentioned in (b) above?

Answer

(a) Initial Audit Engagement: 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.

(b) (i) **Financial Statements Audited by another Auditor – Audit Procedure:** 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.

(ii) **Audit of Financial Statements for the First Time – Audit Procedure:** When the audit of financial statements is being conducted for the first time, the auditor has to perform auditing procedures to obtain sufficient appropriate audit evidence. Since opening balances represent effect of transaction and events of the preceding period and accounting policies applied in the preceding period, the auditor need to obtain evidence having regard to nature of opening balances, materiality of the opening balances and accounting policies. Since it will not be possible for auditor to perform certain procedures, e.g., observing physical verification of inventories, etc. the auditor may obtain confirmation, etc. and perform suitable procedures in respect of fixed assets, investments, etc. The auditor can also obtain management representation with regards to the opening balances.

(c) Drafting Audit Report: 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.

Question 47

M/s LNK's group gratuity scheme's valuation by actuary shows wide variation compared to the previous year's figures. As a Statutory Auditor, how would you deal in this situation?

Answer

Valuation by Actuary: As per SA 620 "Using the Work of an Auditor's Expert", an evaluation of the work of an expert can be done considering the following facts-

(i) When the auditor plans to use the expert's work as audit evidence, he should satisfy himself as to the expert's skills and competence by considering the expert's:

  (1) professional qualifications, license or membership in an appropriate professional body, and

  (2) experience and reputation in the field in which the evidence is sought.

(ii) The objectives and scope of the experts' work.

(iii) A general outline as to specific items in the expert's report.

(iv) Confidentiality of the client's information used by the expert.

(v) The source data used.

(vi) The assumptions and methods used and, if appropriate, their comparison with the prior period.

(vii) The results of the expert's work in the light of auditor's overall knowledge of the business and of the results of his audit procedures.

(viii) The auditor should also satisfy himself that the substance of the expert's findings is properly reflected in the financial statements.

(ix) Consider whether the expert has used the appropriate source data, by making inquiries of the expert.

(x) Conducting audit procedures on the data by the client to the expert to obtain reasonable assurance that the data are appropriate.

The auditor has to evaluate the work of an expert, say, actuary, before adopting the same. This becomes more crucial since M/s LNK's group gratuity scheme's valuation by actuary shows wide variation compared to previous year figures. There is no doubt that appropriateness, reasonableness of assumptions and methods used are the responsibility of the expert, but the auditor has to determine whether they are reasonable based on the auditor's knowledge of the client's business and result of his audit procedures. In the present case, the auditor must verify the reasonableness of assumptions made and methods adopted by the actuary in the evaluation particularly with reference to factors such as rate of return on investments, retirement age, number and salary of employees, etc. Accordingly, the auditor has to satisfy himself whether valuation done by the actuary can be adopted, otherwise he may report on his findings for wide variation.

1

Auditing Standards, Statements and Guidance Notes- An Overview

Question 1

(a) G Ltd. is a mobile phone operating company. Barring the marketing function it had outsourced the entire operations like maintenance of mobile infrastructure, customer billing, payroll, accounting functions, etc. Assist the auditor of G Ltd. as to how he can obtain an understanding of how G Ltd. uses the services of the outsourced agency in its operations. (5 Marks, November, 2013)

Or

In the course of the audit of R Ltd., the audit manager of ABC & Co. observed that R Ltd. has outsourced certain activities to an outsourcing agency. As the engagement partner guide the audit manager in the assessment of services provided by the outsourcing agency in relation to the audit. (4 Marks, May 2011)

(b) M/s Honest Limited has entered into a transaction on 5th March, 2013, near year-end, whereby it has agreed to pay ₹ 5 lakhs per month to Mr. Y as annual retainer-ship fee for "engineering consultation". No amount was actually paid, but ₹ 60 lakhs is provided in books of account as on March 31, 2013.

Your inquiry elicits a response that need-based consultation was obtained round the year, but there is no documentary or other evidence of receipt of the service. As the auditor of M/s Honest Limited, what would be your approach? (5 Marks, November, 2013)

Answer

(a) As per **SA 402 on "Audit Considerations Relating to an Entity Using a Service Organisation"**, when obtaining an understanding of the user entity in accordance with SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including:

(i) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control;

(ii) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;

(iii) The degree of interaction between the activities of the service organisation and those of the user entity; and

(iv) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation.

(b) As per **SA 240 on "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"**, fraud can be committed by management overriding controls using such techniques as Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.

Keeping in view the above, it is clear that Company has passed fictitious journal entries near year end to manipulate the operating results. Also Auditor's enquiry elicited a response that need-based consultation was obtained round the year, but there is no documentary or other evidence of receipt of the service, is not acceptable.

Accordingly, the auditor would adopt the following approach-

If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

(i) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(ii) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(iii) If the auditor withdraws:

(1) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(2) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 2

(a) C & Co., hired Mr. A, Chartered Accountant, to compile its financial statements for the interim period ending on 31st December 2012. Kindly assist Mr. A in drafting scope of engagement letter with specific focus on C & Co's responsibility.

(b) Mr. X was appointed as the auditor of M/s Easygo Ltd. and intends to apply the concept of materiality for the financial statements as a whole. Please guide him as to the factors that may affect the identification of an appropriate benchmark for this purpose.

(4 Marks each, November, 2013)

Answer

(a) As per **SRS 4410 "Engagements to Compile Financial Information"**, the engagement letter to be issued by Mr. A should state the following as management's responsibility:

(i) the accuracy and completeness of the information supplied to us, including maintenance of adequate accounting records and internal controls and selection and application of appropriate accounting policies.

(ii) preparation and presentation of the financial statements of the entity, in accordance with the applicable laws and regulations, if any.

(iii) safeguarding the assets of the entity and also establishing appropriate controls designed to prevent and detect fraud and other irregularities.

(iii) ensuring that the activities of the entity are carried in accordance with applicable laws and regulations and that it institutes appropriate controls to prevent and detect any non-compliance.

(iv) Ensuring complete disclosure of all material and relevant information to the accountant.

(b) **SA 320 "Materiality in Planning and Performing an Audit"** prescribes the use of Benchmarks in Determining Materiality for the Financial Statements as a Whole.

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

(i) The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);

(ii) Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);

(iii) The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;

(iv) The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and

(v) The relative volatility of the benchmark.

Question 3

(a) In the course of audit of Z Ltd, its auditor wants to rely on audit evidence obtained in previous audit in respect of effectiveness of internal controls instead of retesting the same during the current audit. As an advisor to the auditor kindly caution him about the factors that may warrant a re-test of controls. (4 Marks, May, 2013)

(b) In audit plan for T Ltd, as the audit partner you want to highlight the sources of misstatements, arising from other than fraud, to your audit team and caution them. Identify the sources of misstatements. (4 Marks, May, 2013)

Or

In the course of audit of T Ltd., the audit team is not sure of the possible source of misstatements in the financial statements. As the audit manager identify the sources of misstatements. (4 Marks, May 2011)

(c) The auditor of H Ltd. Wanted to obtain confirmation from its creditors. But the management made a request to the auditor not to seek confirmation from certain creditors citing disputes. Can the auditor of H Ltd. accede to this request?

(4 Marks, May, 2013)

(d) R & Co, a firm of Chartered Accountants have not revised the terms of engagements and obtained confirmation from the clients, for last 5 years despite changes in business and professional environment. Please elucidate the circumstances that may warrant the revision in terms of engagement. (4 Marks, May, 2013)

Answer

(a) As per **SA 330 on "The Auditor's Responses to Assessed Risks"**, changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance.

The auditor's decision on whether to rely on audit evidence obtained in previous audits for control is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment.

Factors that may warrant a re-test of controls are-

(i) A deficient control environment.

(ii) Deficient monitoring of controls.

(iii) A significant manual element to the relevant controls.

(iv) Personnel changes that significantly affect the application of the control.

(v) Changing circumstances that indicate the need for changes in the control.

(vi) Deficient general IT-controls.

(b) According to **SA 450 "Evaluation of Misstatements identified during the Audit"**, the following are the sources of misstatements arising from other than fraud -

(i) An inaccuracy in gathering or processing data from which the financial statements are prepared;

(ii) An omission of an amount or disclosure;

(iii) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of facts; and

(iv) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

(c) **SA 505, "External Confirmations"**, establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. It requires that the auditor should employ external confirmation procedures in consultation with the management. The auditor may come across certain situations in which the management may request him not to seek external confirmation from certain parties because of dispute with the trade payables, etc. The management, for example, might make such a request on the grounds that due to a dispute with the particular trade payable, the request for confirmation might aggravate the sensitive negotiations between the entity and the trade payables.

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

If the auditor of H Ltd. agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should document the reasons for acceding to the management's request and should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter. While considering the validity of request, in case the auditor of H Ltd. reaches at a conclusion that the same was not valid, he may appropriately modify the report.

(d) As per **SA 210 on "Agreeing the Terms of Audit Engagements"**, the auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

(i) Any indication that the entity misunderstands the objective and scope of the audit.

(ii) Any revised or special terms of the audit engagement.

(iii) A recent change of senior management.

(iv) A significant change in ownership.

(v) A significant change in nature or size of the entity's business.

(vi) A change in legal or regulatory requirements.

(vii) A change in the financial reporting framework adopted in the preparation of the financial statements.

(viii) A change in other reporting requirements.

Question 4

Write short notes on Corresponding figures. *(4 Marks, May, 2013)*

Answer

Corresponding Figures: As per SA 710 "Comparative Information—Corresponding Figures and Comparative Financial Statements", "corresponding figures" is a comparative information where amounts and other disclosures for the preceding period are included as part of the current period financial statements, and are intended to be read in relation to the amounts and other disclosures relating to the current period. These corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period financial statements intended to be read only in relationship to the current period figures.

Question 5

As a statutory auditor of a company, comment on the following:

(a) A fire broke out on 15th May, 2012, in which material worth ₹ 50 lakhs which was lying in stock since 1st March, 2012 was totally destroyed. The financial statements of the company have not been adopted till the date of fire. The management of the company argues that since the loss occurred in the year, 2012-13, no provision for the loss needs to be made in the financial statements for 2011-12.

(b) While verifying the employee records in a company, it was found that a major portion of the labour employed was child labour. On questioning the management, the auditor was told that it was outside his scope of the financial audit to look into the compliance with other laws. *(5 Marks each, November, 2012)*

Answer

(a) **Event occurring after the balance sheet date:** This case requires attention to SA 560 "Subsequent Events" and AS 4 "Contingencies and Events occurring after the Balance Sheet Date".

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 or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.

AS 4 also requires disclosure of the non-adjusting event, in the report of the approving authority.

Further, 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.

The event took place after the close of the accounting year and does not relate to conditions existing at the balance sheet date. Thus, it will have no effect on items appearing at the balance sheet date because as per AS 4 "Contingencies and Events Occurring after Balance Sheet Date" have to be adjusted that provide evidence of conditions existing as at the balance sheet date. However, the auditor has to ensure that this loss will not materially affect the substratum of the enterprises as per its size, nature and complexity of operations.

Thus, subject to satisfaction in respect of non-violation of going concern concept, the company has correctly accounted by not providing provision. However, the auditor is required to ensure the proper disclosure of abovementioned event.

(b) Compliance with Other Laws: As per SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", the auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements including tax and labour laws.

Further, non-compliance with other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements.

In the instant case, major portion of the labour employed in the company was child labour. While questioning by auditor, reply of the management that it was outside his scope of financial audit to look into the compliance with other laws is not acceptable as it may have a material effect on financial statements.

Thus, auditor should ensure the disclosure of above fact and provision for the cost of fines, litigation or other consequences for the entity. In case if the auditor concludes that non-compliance has a material effect on the financial statements and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statement.

Question 6

While carrying out the statutory audit of a large entity, what are the substantive procedures to be performed to assess the risk of material misstatement? (8 Marks, November, 2012)

Answer

Substantive Procedures to be performed to assess the risk of material misstatement: As per SA 330, "The Auditor's Response to Assessed Risk", substantive procedure is an audit procedure designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures.

Test of Details: The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size.

Substantive Analytical Procedure: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

Alternative Solution:

SA 330 'The Auditor's Responses to Assessed Risks' requires the auditor to design and perform substantive procedures for each material class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement.

This requirement reflects the facts that:

- The auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and;
- There are inherent limitations to internal control, including management override.

Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient to reduce the audit risk to an acceptably low level;
- Only tests of detail are appropriate;
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

Based on the above, the auditor's substantive procedures would include the following audit procedures related to the financial statement closing process:

- Agreeing or reconciling the financial statements with the underlying accounting records and
- Examining material journal entries and other adjustments made during the course of preparing the financial statements.

Question 7

As an auditor how will you verify the existence of Related Parties? (8 Marks, November, 2012)

Or

Elaborate how the Statutory Auditor can verify the existence of related parties for the purpose of reporting under Accounting Standard 18. (8 Marks, May, 2006)

Answer

Verification of Existence of Related Parties: As per SA 550 "Related Parties", during the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. Example-

(i) Entity Income Tax Returns.

(ii) Information supplied by the entity to regulatory authorities.

(iii) Shareholder registers to identify the entity's principal shareholders.

(iv) Statements of conflicts of interest from management and those charged with governance.

(v) Records of the entity's investments and those of its pension plans.

(vi) Contracts and agreements with key management or those charged with governance.

(vii) Significant contracts and agreements not in the entity's ordinary course of business.

(viii) Specific invoices and correspondence from the entity's professional advisors.

(ix) Life insurance policies acquired by the entity.

(x) Significant contracts re-negotiated by the entity during the period.

(xi) Internal auditors' reports.

(xii) Documents associated with the entity's filings with a securities regulator (e.g., prospectuses).

Arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions.

In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

(i) Bank, legal and third party confirmations obtained as part of the auditor's procedures;

(ii) Minutes of meetings of shareholders and of those charged with governance; and

(iii) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

Question 8

(a) R & Co. is the statutory auditor of S Ltd. For the financial year ended on 31st March 2012, S Ltd had disclosed in the notes (Note No. X) "The state pollution control board had ordered the closure of the company's only manufacturing plant on the ground that it is environmentally damaging, which the company had challenged in a law suit. Pending the outcome of the law suit the financial statements are prepared on a going concern basis". Further the financial statements prepared by the management of S Ltd include financial statements of certain branches which are audited by other auditors. What are the reporting responsibilities of R & Co.? (10 Marks, May, 2012)

(b) In the course of the statutory audit of Z Ltd, its statutory auditors, having determined that the work of internal auditor is likely to be adequate for the purpose of statutory audit, wanted to use the work of internal auditor in respect of physical verification of fixed assets. How an evaluation of this specific work done by the internal auditor can be done? (5 Marks, May, 2012)

Answer

(a) Reporting Responsibilities of Statutory Auditor: This question involves two broad aspect with respect to reporting requirements i.e. (i) one which deals with Going Concern aspect where the company has gone for legal suit and (ii) other is work done by other auditors.

As per facts of the case, the State Pollution Control Board has issued the closure order for S Ltd., on account of environmental damaging by its only manufacturing plant. However, S Ltd had challenged the same by way of a law suit. Due to pendency of the outcome of the legal suit, the company has prepared its financial statements on going concern basis.

As per SA 570 "Going Concern", under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions.

The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. For this the auditor may take the help of expert.

As per SA 620, "Using the Work of an Auditor's Expert", if expertise in a field is necessary to obtain sufficient appropriate audit evidence, he may determine to use the work of an auditor's expert. On the basis of expert's opinion he may decide to rely or not on assessment of management.

As per SA 570 "Going Concern", pending legal proceedings is a condition that, individually, may cast significant doubt about the going concern assumption. Existence of above condition signifies that a material uncertainty exists.

Further, when the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

(i) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(ii) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph as per SA 706 "Emphasis of matter paragraphs and other matter paragraphs in the Independent Auditor's Report", in the auditor's report to:

(i) Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and to

(ii) Draw attention to the note in the financial statements that discloses the matters

In the present situation, management of S Ltd. had disclosed the above fact in the financial statement. Further, use of the going concern assumption is appropriate but a material uncertainty exists so assuming the assessment and disclosure of S Ltd. in order, R & Co. should include an Emphasis of Matter paragraph in the auditor's report.

Further, as per SA 600 "Using the work of Another Auditor", when the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/ branches/ subsidiaries or other components audited by other auditors.

Note: Alternative answer is possible assuming that company is not going concern, hence auditor should issue adverse report.

(b) Evaluation of Specific Work Done by Internal Auditor: The statutory auditor should as a part of his audit, carryout general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor.

As per SA 610 "Using the Work of Internal Auditors", the nature, timing and extent of the audit procedures performed on specific work of the internal auditors will depend on the external auditor's assessment of the risk of material misstatement, the evaluation of the internal audit function, and the evaluation of the specific work of the internal auditors. Such audit procedures may include examination of items already examined by the internal auditors, examination of other similar items; and observation of procedures performed by the internal auditors.

Further, to determine the adequacy of specific work performed by the internal auditors for the external auditor's purposes, the external auditor shall evaluate whether:

(i) The work was performed by internal auditors having adequate technical training and proficiency;

(ii) The work was properly supervised, reviewed and documented;

(iii) Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;

(iv) 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

(v) Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

Question 9

In the course of audit of Q Ltd, its statutory auditor wants to be sure of the adequacy of related party disclosures? Kindly guide the auditor in identifying the possible source of related party information. *(8 Marks, May, 2012)*

Answer

Identification of possible sources for Related Parties' information: As per SA 550 on, "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties. However, it is the management, which is primarily responsible for identification of related parties. The duties of an auditor with regard to reporting of related party transaction as required by Accounting Standard 18 "Related Party Disclosures" is given in SA 550.

(i) SA 550 requires that to identify names of all known related parties, the auditor may inspect records or documents that may provide information about related party relationships and transactions, for example entity income tax returns, information supplied by the entity to regulatory authorities, shareholder registers to identify the entity's principal shareholders, statements of conflicts of interest from management and those charged with governance, records of the entity's investments and those of its pension plans, contracts and agreements with key management or those charged with

governance, significant contracts and agreements not in the entity's ordinary course of business, specific invoices and correspondence from the entity's professional advisors, life insurance policies acquired by the entity, significant contracts re-negotiated by the entity during the period, internal auditors' reports, documents associated with the entity's filings with a securities regulator (e.g., prospectuses).

(ii) Some arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions as an arrangement involves a formal or informal agreement between the entity and one or more other parties for such purposes as the establishment of a business relationship through appropriate vehicles or structures, the conduct of certain types of transactions under specific terms and conditions or the provision of designated services or financial support.

Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor include participation in unincorporated partnerships with other parties, agreements for the provision of services to certain parties under terms and conditions that are outside the entity's normal course of business, guarantees and guarantor relationships etc.

(iii) Obtaining further information on significant transactions outside the entity's normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and, where the applicable financial reporting framework establishes related party requirements, to identify the risks of material misstatement. In addition, the auditor needs to be alert for transactions which appear unusual in the circumstances and which may indicate the existence of previously unidentified related parties. Examples of transactions outside the entity's normal course of business may include complex equity transactions, such as corporate restructurings or acquisitions, transactions with offshore entities in jurisdictions with weak corporate laws, the leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged, sales transactions with unusually large discounts or returns, transactions with circular arrangements, for example, sales with a commitment to repurchase, transactions under contracts whose terms are changed before expiry etc.

(iv) Finally, the auditor should also obtain a written representation from the management concerning the completeness of information provided regarding the identification of related parties.

Question 10

In the course of audit of A Ltd you suspect the management has indulged in fraudulent financial reporting? State the possible source of such fraudulent financial reporting.

(6 Marks, May, 2012)

Answer

Possible Sources of Fraudulent Financial Reporting: As per SA 240, "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements", fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. It may be accomplished by manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared or Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information or intentional misstatements involve intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure etc.

It often involves management override of controls, misappropriation of assets etc that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

(i) Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.

(ii) Inappropriately adjusting assumptions and changing judgments used to estimate account balances.

(iii) Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.

(iv) Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.

(v) Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.

(vi) Altering records and terms related to significant and unusual transactions.

(vii) Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).

(viii) Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).

(ix) Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).

(x) Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 11

The auditor of SS Ltd. accepted the gratuity liability valuation based on the certificate issued by a qualified actuary. However, the auditor noticed that the retirement age adopted is 65 years as against the existing retirement age of 60 years. The company is considering a proposal to increase the retirement age. Comment. *(5 Marks, November, 2011)*

Answer

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

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

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

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

Question 12

State briefly the basic elements of Management Representation Letter.(2 Marks, November, 2011)

Answer

Basic Elements of a Management Representation Letter: As per SA 580 "Written Representations", some of the basic elements of a Management Representation letter are-

(1) It is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence.

(2) It does not include financial statements, the assertions therein, or supporting books and records.

(3) The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement.

(4) The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

Question 13

(a) While auditing Z Ltd., you observe certain material financial statement assertions have been based on estimates made by the management. As the auditor how do you minimize the risk of material misstatements? (6 Marks, May 2011)

(b) The management of S Ltd. requests you not to seek confirmation from its debtors. As the auditor of S Ltd., what can be an appropriate response? (6 Marks, May 2011)

Or

The accountant of C Ltd. has requested you, not to send balance confirmations to a particular group of debtors since the said balances are under dispute and the matter is pending in the Court. As a Statutory Auditor, how would you deal? (4 Marks, May, 2005)

Answer

(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) **SA 505 "External Confirmations"**, establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. If the management refuses to allow the auditor to a send a confirmation request, the auditor shall:

(i) Inquire as to Management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness,

(ii) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures, and

(iii) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those in charge of governance and also determine its implication for the audit and his opinion.

Question 14

Y Ltd. engaged an actuary to ascertain its employee cost, gratuity and leave encashment liabilities. As the auditor of Y Ltd., you would like to use the report of the actuary as an audit evidence. How do you evaluate the work of the actuary? (8 Marks, May, 2011)

Answer

Evaluating the work of an Auditor's Expert: As per SA 620 "Using the Work of an Auditor's Expert", when management has used a management's expert in preparing the financial statements, the auditor's decision on whether to use an auditor's expert may also be influenced by such factors as:

(i) The nature, scope and objectives of the management's expert's work.

(ii) Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.

(iii) The extent to which management can exercise control or influence over the work of the management's expert.

(iv) The management's expert's competence and capabilities.

(v) Whether the management's expert is subject to technical performance standards or other professional or industry requirements.

(vi) Any controls within the entity over the management's expert's work.

However, an evaluation of the work of an expert can be done considering the following facts:

(i) When the auditor plans to use the expert's work as audit evidence, he should satisfy himself as to the expert's skills and competence by considering the expert's:

(1) professional qualifications, license or membership in an appropriate professional body, and

(2) experience and reputation in the field in which the evidence is sought.

(ii) The objectives and scope of the experts' work.

(iii) A general outline as to specific items in the expert's report.

(iv) Confidentiality of the client's information used by the expert.

(v) The source data used.

(vi) The assumptions and methods used and, if appropriate, their comparison with the prior period.

(vii) The results of the expert's work in the light of auditor's overall knowledge of the business and of the results of his audit procedures.

(viii) The auditor should also satisfy himself that the substance of the expert's findings is properly reflected in the financial statements.

(ix) Consider whether the expert has used the appropriate source data, by making inquiries of the expert.

(x) Conducting audit procedures on the data by the client to the expert to obtain reasonable assurance that the data are appropriate.

Question 15

Write short notes on Frauds committed through supplier's ledger. (4 Marks, May, 2011)

Or

Write short notes on Frauds through supplier ledger. (4 Marks, November 2008)

Answer

Frauds Committed through Suppliers Ledger: Fraud through supplies ledger could be made in any of the following ways, which the auditor has to take care of:

(i) Inflating suppliers account with fictitious or duplicate invoices and subsequent misappropriations as if payments are made to the supplier

(ii) Suppressing credit notes issued by the suppliers and withdrawing the corresponding amount not claimed by them.

(iii) Withdrawing amounts which remain unclaimed for more than the normal time limit for one reason or other by showing the same have been paid to the parties.

(iv) Inflating values of items purchased and collecting the excess from suppliers i.e. accepting invoices at prices considerably higher than the market price and collecting the excess claim from the suppliers directly.

Question 16

A Co. Ltd. has not included in the Balance Sheet as on 31-03-2010 a sum of ₹ 1.50 crores being amount in the arrears of salaries and wages payable to the staff for the last 2 years as a result of successful negotiations which were going on during the last 18 months and concluded on 30-04-2010. The auditor wants to sign the said Balance Sheet and give the audit report on 31-05-2010. The auditor came to know the result of the negotiations on 15-05-2010. Comment. (5 Marks, November, 2010)

Answer

Subsequent Events: 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.

Question 17

While doing audit, Ram, the Auditor requires reports from experts for the purpose of Audit evidence. What types of reports/opinions he can obtain and to what extent he can rely upon the same? (4 Marks, November, 2010)

Answer

Using the Work of an Auditor's Expert: As per SA 620, "Using the Work of an Auditor's Expert", during the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert.

While doing audit, Ram, the auditor can obtain the following types of reports, or options or statements of an expert for the purpose of audit evidence:

(i) The valuation of complex financial instruments, land and buildings, plant and machinery, jewelry, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.

(ii) The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.

(iii) The estimation of oil and gas reserves.

(iii) The valuation of environmental liabilities, and site clean-up costs.

(iv) The interpretation of contracts, laws and regulations.

(v) The analysis of complex or unusual tax compliance issues.

When the auditor intends to use the work of an expert, he shall evaluate the adequacy of the auditor's expert's work, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence; if that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and if that expert's work involves the use of source data that is significant to his work, the relevance, completeness, and accuracy of that source data.

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, he shall agree with that expert on the nature and extent of further work to be performed by that expert; or perform further audit procedures appropriate to the circumstances.

Question 18

Write short notes on Guidance note on Audit of Miscellaneous Expenditure (revised).

(5 Marks, November, 2010)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 19

S Ltd. issued Bonds to the tune of ₹ 100 lacs and provided security to the tune of ₹ 80 lacs for the same. It insists that it will disclose the Bonds as "Secured" in the Balance Sheet of the Company. Comment. (5 Marks, May, 2010)

Answer

Disclosure in Balance Sheet: Prima facie, the Bonds issued to the tune of ₹ 100 lacs are provided with security to the tune of ₹ 80 lacs i.e. neither fully secured nor unsecured. Guidance Note on the "Terms used in Financial Statements" issued by ICAI, states "Secured Loans" as loan secured wholly or partly against an asset. Hence the Bonds should be classified under 'Secured Loans' for the purpose of disclosure in the Balance Sheet. However the nature of security should be clearly specified.

Question 20

(a) In the course of audit of ABC Ltd. its management refuses to provide written representations. As an auditor what is your duty?

(b) While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?

(c) What are the auditor's responsibilities in respect of corresponding figures?

(d) IT systems also pose specific risks to an entity's internal control? What are those risks?

(4 Marks each, May, 2010)

Answer

(a) Duty of an Auditor if management refuses to provide written representations: As per SA 580 "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 in accordance with SA 705 "Modifications to the Opinion in the Independent Auditor's Report".

(b) Risk Factors while applying sampling techniques: As per SA 530 "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 exists 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 misstatements 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.

(c) Auditor's responsibilities in respect of corresponding figures: As per SA 710 "Comparative Information—Corresponding Figures and Comparative Financial Statements", in respect of corresponding figures, the auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

(a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and

(b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of SA 560 "Subsequent Events".

As required by SA 580, "Written Representations", the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year's statement of profit and loss.

(d) Specific Risk to an Entity's internal Control: As per SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", IT system also poses specific risks to an entity's Internal Control. They are–

(i) Reliance on systems or programs that are inaccurately processing data, processing inaccurate data or both

(ii) Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risk may arise when multiple users access a common database.

(iii) The possibility of IT personnel gaining access beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.

(iv) Unauthorised changes to data in Master files

(v) Unauthorised changes to systems or programs.

(vi) Failure to make necessary changes to systems or programs.

(vii) In appropriate manual intervention

(viii) Potential loss of data or inability to access data as required.

Question 21

Comment on the following:

(a) 'A' Limited has paid minimum alternate tax under Section 115 JB of the Income Tax Act, 1961, for the year ended 31st March, 2009. The company wants to disclose the same as an 'Asset' since the company is eligible to claim credit for the same.

(5 Marks, November, 2009)

Or

For the year ended 31st March, 2007, a company has paid Minimum Alternative tax under section 115 JB of the Income Tax Act, 1961. The company wants to disclose the same as an 'Asset' since the company is eligible to claim credit for the same.

(5 Marks, November 2007)

(b) Moon Limited replaced its statutory auditor for the Financial year 2008-09. During the course of audit, the new auditor found a credit item of ₹ 5 lakhs. On enquiry, the company explained him that it is, a very old credit balance. The creditor had neither approached for the payment nor he is traceable. Under the circumstances no confirmation of the credit balance is available. (5 Marks, November, 2009)

(c) The statutory audit of Fortune Limited for the year ended on 31.03.2009 was completed and auditor also submitted his report with the audited Financial Statements to the management of the company. Thereafter, the management of the company approached the auditor to revise certain items in the Financial Statements.

(5 Marks, November, 2009)

Answer

(a) Disclosure of MAT: As per Para 6 of the Guidance Note issued by ICAI on "Accounting for credit available in respect of MAT under the IT Act, 1961", although MAT credit is not a deferred tax asset under AS 22, yet it gives rise to expected future economic benefit in the form of adjustment of future income tax liability arising within the specific period.

The Framework for the preparation and presentation of financial statements, issued by the ICAI, defines the term 'asset' is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

MAT paid in a year in respect of which the credit is allowed during the specified period under the Income Tax Act is a resource controlled by the company as a result of past event, namely the payment of MAT. The MAT credit has expected future economic benefits in the form of its adjustment against the discharge of the normal tax liability if the same arises during the specified period. Accordingly, such credit is an asset.

According to the Framework, once an item meets the definition of the term 'Asset', it has to meet the criteria for recognition of an asset, so that it may be recognised as such in the financial statements.

Para 88 of the Framework provides the following criteria for recognition of an asset:

An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

Thus, if the auditor is satisfied that the probability of the company to claim the said credit is high, it could recognise the same as an asset. In balance sheet it could be shown under the head "Loans and Advances" as MAT credit entitlement.

(b) External Confirmation: This is a case of external confirmation, covered by SA 505 "External Confirmations". The identities of trade payables are not traceable to confirm the credit balance as appearing in the financial statement of the company. It is also not a case of pending litigation.

It might be a case that an income of ₹5 lakhs had been hidden in previous year/s. The statutory auditor should examine the validity of the credit balance as appeared in the company's financial statements. He should obtain sufficient evidence in support of the balance. He should apply alternative audit procedures to get documentary proof for the transaction/s and should not rely entirely on the management representation. Finally, he should include the matter by way of a qualification in his audit report to the members.

(c) As per the Guidance Note on Revised Accounts of Companies Before Circulation to Shareholders, management can revise its accounts after adoption on which report has been issued by the Auditors, but before circulation to the shareholders.

In the instant case, the statutory auditor should ascertain whether the original audit report along with audited accounts has been circulated to the share-holders. If not, he can issue a revised report on the amended financial statements as laid down by the said Guidance Note:

(i) For the same, the revised accounts must be re-approved by the Board of Directors of the company.

(ii) He should ask the company to return all the original copies of the earlier audit report along with the audited accounts.

(iii) The fact of revision of financial statements with reasons should be incorporated in the Directors' Report. If it is neither included nor found adequately disclosed in the Director's Report, he should include the fact with figures and reasons in his revised audit report to the shareholders. He should specifically mention that it is a revised audit report.

Note: Section 131 of the Companies Act, 2013 prescribes the voluntary revisions of the financial statements or Board's report which is yet to be notified.

Question 22

Briefly explain Audit procedures on subsequent events. (4 Marks, November, 2009)

Answer

Audit Procedures on Subsequent Events: As per SA 560 "Subsequent Events", events occurring between the dates of balance sheet and audit report and the facts that become known to the auditor after the date of the auditor's report.

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following:

(a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

(c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(d) Reading the entity's latest subsequent interim financial statements, if any.

When, as a result of the procedures performed as required the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.

Question 23

Explain briefly duties and responsibilities of an auditor in case of material misstatement resulting from Management Fraud. (6 Marks, November, 2009)

Answer

Duties & Responsibilities of an auditor in case of Material misstatement resulting from management fraud: Misstatement in the financial statements can arise from fraud or error. The term fraud refers to an 'Intentional Act' by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. The auditor, conducting an audit, is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

As described in SA 200, the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

Additionally, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 24

Comment on the following:

(a) You are appointed to compile financial statements of Y & Co. for tax purposes. During the course of work, you learn that the inventory is grossly understated. On pointing the same, the partners of Y & Co. tell you that since you are not conducting an audit, the said figures duly certified by the firm should be accepted. (5 Marks, June 2009)

(b) While conducting statutory Audit of ABC Ltd., you come across IOUs amounting to ₹ 2 crores as against a cash balance shown in books of ₹ 2.10 crores. You also observe that despite similar high balances throughout the year, small amounts of ₹ 50,000 are withdrawn from the bank to meet day-to-day expenses. (5 Marks, June 2009)

(c) Z Ltd. had appointed an outside expert to assess accrued gratuity liability of the company. Based on the said report, the company provides ₹ 80 lakhs as gratuity in the financial statements. (4 Marks, June 2009)

(d) A Company's net worth is eroded and creditors are unpaid due to liquidity constraints. The management represents to the statutory auditor that the promoter's wife is expected to give an unsecured loan to meet the liquidity constraints and that negotiations are underway to secure large export orders. (4 Marks, June 2009)

Answer

(a) Compilation of Financial Statements: According to SRS 4410 "Engagements 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.

As per guidance note on Tax Audit under section 44AB of the Income Tax Act, 1961, the stock auditor should study the procedure followed by the assessee in taking the inventory of closing stock at the end of the year and the valuation thereof. The tax auditor should also examine the basis adopted for ascertaining the cost and this basis should be consistently followed. It is very necessary for an auditor to ensure that the method followed for valuation of stock results in disclosure of correct profit and gains.

In the instant case, appointment was made to compile financial statements for tax audit purpose of Y & Co., a firm. It is our duty of to ensure that method followed for valuation of stock results in disclosure of correct profit and gains.

In this case the stock valuation was grossly understated. Consequently, disclosure of profit is also not correct. Hence, contention of the Y & Co., that you are not the conducting an audit, the said figures duly certified by the firm should be accepted is not correct.

(b) Material Misstatements: According to SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" when the auditor comes across such circumstances indicating the possible misstatements resulting from the fraud then the auditor needs to consider the impact of fraud on financial statements and its disclosure in the audit report. In this case, the circumstances indicate that the possible misstatement in financial statements is due to fraud and error and the auditor must investigate further to consider effect on financial statements.

The Guidance Note on Audit of Cash and Bank balances also mentions that if the entity is maintaining an unduly large balance of cash, he should carry out surprise verification of cash more frequently to ascertain whether it agrees. If cash in hand is not in agreement with the book balance, he should seek explanations and if the same are not satisfactory should state the said fact appropriately in his Audit Report.

(c) SA 620 "Using the work of an Auditor's Expert" 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) Going Concern Assumption: In this case, it is subjective, but prima-facie a mere expectation of future cash flows from the promoter's wife without any firm commitment and the possibility of an export order being negotiated, may not that be sufficient appropriate audit evidence of mitigating factors for resolving the going concerns question under SA 570 "Going Concern".

Question 25

The audit report of P Ltd. for the year 2007-08 contained a qualification regarding non- provision of doubtful debts. As the statutory auditor of the company for the year 2008-09, how would you report, if:

(i) The company does not make provision for doubtful debts in 2008-09?

(ii) The company makes adequate provision for doubtful debts in 2008-09?

(8 Marks, June 2009)

Answer

Auditor's responsibilities in cases where audit report for an earlier year is qualified is given in SA 710 "Comparative Information – Corresponding Figures and Comparative Financial Statements". As per SA 710, When the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.

SA 710 further states that if the auditor's report on the prior period, as previously issued, included a qualified opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

(i) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or

(ii) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

In the instant Case, if P Ltd. does not make provision for doubtful debts the auditor will have to modify his report for both current and previous year's figures as mentioned above. If however, the provision is made, the auditor need not refer to the earlier year's modification.

Question 26

Comment on the following:

(a) You are the auditor of Easy Communications Ltd. for the year 2007–08. The inventory as at the end of the year i.e. 31.3.08 was ₹ 2.25 crores. Due to unavoideable circumstances, you could not be present at the time of annual physical verification. Under the above circumstances how would you ensure that the physical verification conducted by the management was in order?

(b) You have been appointed as the auditor of Good Health Ltd. for 2007-08 which was audited by CA Trustworthy in 2006-07. As the Auditor of the company state the steps you

would take to ensure that the Closing Balances of 2006-07 have been brought to account in 2007-08 as Opening Balances and the Opening Balances do not contain misstatements. *(5 Marks each, November 2009)*

Answer

(a) As per **SA 501 "Audit Evidence – Additional Considerations for Specific Items",** the auditor should perform audit procedures, designed to obtain sufficient appropriate audit evidence during his attendance at physical inventory counting. SA 501 is additional guidance to that contained in SA 500, "Audit Evidence", with respect to certain specific financial statement amounts and other disclosures.

If the auditor is unable to be present at the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded. The auditor would also verify the procedure adopted, treatment given for the discrepancies noticed during the physical count. The auditor would also ensure that appropriate cut off procedures were followed by the management. He should also get management's written representation on (a) the completeness of information provided regarding the inventory, and (b) assurance with regard to adherence to laid down procedures for physical inventory count.

By following the above procedure it will be ensured that the physical verification conducted by the management was in order.

(b) As per **SA 510 "Initial Audit Engagements—Opening Balances"**, in conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

(i) Opening balances contain misstatements that materially affect the current period's financial statements; and

(ii) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Being new assignment audit evidence regarding opening balances can be obtained by perusing the copies of the audited financial statements.

For current assets and liabilities some audit evidence can ordinarily be obtained as part of audit procedures during the current period. For example, the collection/payment of opening balances of receivables and payables will provide audit evidence as to their existence, rights and obligations, completeness and valuation at the beginning of the period.

In respect of other assets and liabilities such as fixed assets, investments long term debt, the auditor will examine the records relating to opening balances. The auditor may also be able to get confirmation from third parties (e.g., balances of long term loan obtained from banks).

Question 27

Write short notes on Situations where external confirmations can be used.

(4 Marks, November, 2007)

Or

Write short notes on Eight situations of external confirmations. *(4 Marks, May, 2007)*

Answer

Situations where external confirmations can be used:

(i) Bank balance from bankers

(ii) Account receivable balances

(iii) Stocks held by third parties

(iv) Property title deeds held by third parties

(v) Investments purchased but delivery not taken

(vi) Loan from lenders

(vii) Account payable balances

(viii) Long outstanding share application money.

Question 28

You notice a misstatement resulting from fraud or suspected fraud during the audit and conclude that it is not possible to continue the performance of audit. As a Statutory Auditor, how would you deal? *(5 Marks, November, 2007)*

Answer

Impossibility to continue the performance of audit: According to SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", if, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(c) If the auditor withdraws:

(i) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 29

"The auditors should communicate audit matters of governance interest arising from the audit of financial statements with those charged with the governance of an entity". Briefly state the matters to be included in such Communication. (8 Marks, November, 2006)

Answer

Communications of audit matters with those charged with governance: As per SA 260 "Communication with those Charged with Governance", the auditor shall communicate with those charged with governance, the responsibilities of the auditor in relation to the financial statement audit, including that:

(a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and

(b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

The auditor shall communicate with those charged with governance the following:

(a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

(b) Significant difficulties, if any, encountered during the audit;

(c) Unless all of those charged with governance are involved in managing the entity:

(i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and

(ii) Written representations the auditor is requesting; and

(d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

Question 30

State the reporting responsibility of an auditor in the context of non-compliance of Law and Regulation in an audit of Financial Statement. (8 Marks, November, 2006)

Answer

Reporting responsibility of an auditor in the context of non-compliance of Law and Regulation: According to SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statements", the reporting responsibilities of an Auditor may be divided into the following categories-

Reporting Non-Compliance to Those Charged with Governance: Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated by the auditor, the auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

If, in the auditor's judgment, the non-compliance referred above is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.

If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

Reporting Non-Compliance in the Auditor's Report on the Financial Statements: If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with SA 705 express a qualified or adverse opinion on the financial statements.

If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with SA 705.

If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor's opinion in accordance with SA 705.

Reporting Non-Compliance to Regulatory and Enforcement Authorities: If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity.

Question 31

Write short notes on Reporting on a compilation engagements. (4 Marks, November, 2006)

Answer

Reporting on a compilation engagements: As per SA 4410 "Engagements to Compile Financial Information", the report on compilation engagements should, ordinarily, be in the following layout:

(a) *Title*: The title of the report should be "Accountant's Report on Compilation of Unaudited Financial Statements" (and not "Auditor's Report");

(b) *Addressee*: The report should ordinarily be addressed to the appointing authority;

(c) Identification of the financial information also noting that it is based on the information provided by the management;

(d) When relevant, a statement that the accountant is not independent of the entity;

(e) A statement that the management is responsible for:

- ♦ completeness and accuracy of the underlying data and complete disclosure of all material and relevant information to the accountant;
- ♦ maintaining adequate accounting and other records and internal controls and selecting and applying appropriate accounting policies;
- ♦ preparation and presentation of financial statements or other financial information in accordance with the applicable laws and regulations, if any;
- ♦ establishing controls to safeguard the assets of the entity and preventing and detecting frauds or other irregularities;
- ♦ establishing controls for ensuring that the activities of the entity are carried out in accordance with the applicable laws and regulations and preventing and detecting any non-compliance;

(f) A statement that the engagement was performed in accordance with this Standard on Related Services;

(g) A statement that neither an audit nor a review has been carried out and that accordingly no assurance is expressed on the financial information;

(h) A paragraph, when considered necessary, drawing attention to the disclosure of material departures from the identified financial reporting framework;

(i) Date of the report;

(j) Place of signature; and

(k) Accountant's signature.

The financial statements or other financial information compiled by the accountant should contain a reference such as "Unaudited," "Compiled without Audit or Review" and also "Refer to Compilation Report" on each page of the financial information or on the front of the complete set of financial statements.

Question 32

A Company gets its accounting data processed by a third party to achieve cost reduction. As a Statutory Auditor of such a company, what are the additional precautions/checks that you would consider for conduct of the audit? (8 Marks, May, 2006)

Answer

Precaution to be taken by auditor in case accounting data processed by third party: Processing of accounting data may be given to a third party on account of various considerations such as economy, own computer working to full capacity, an interim measures restricting accessibility to sensitive information, etc. A client may use a service organisation such as one that executes transactions and maintains related accountability or records transactions and processes related data (e.g., a computer systems service organisation). If a client uses a service organisation, certain policies, procedures and records maintained by the service organisation might be relevant to the audit of the financial statements of the client. Consequently, the auditor would consider the nature and extent of activities undertaken by service organisations so as to determine whether those activities are relevant to the audit and, if so, to assess their effect on audit risk.

As per SA 402 "Audit Considerations relating to an Entity using a Service Organization", when obtaining an understanding of the user entity in accordance with SA 315, the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including:

(a) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control;

(b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;

(c) The degree of interaction between the activities of the service organisation and those of the user entity; and

(d) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation.

Information on the nature of the services provided by a service organisation may be available from a wide variety of sources, such as user manuals; system overviews; technical manuals; the contract or service level agreement between the user entity and the service organisation; reports by service organisations, internal auditors or regulatory authorities on controls at the service organisation; reports by the service auditor, including management letters, if available.

Knowledge obtained through the user auditor's experience with the service organisation, for example through experience with other audit engagements, may also be helpful in obtaining an understanding of the nature of the services provided by the service organisation. This may be particularly helpful if the services and controls at the service organisation over those services are highly standardized.

Question 33

Answer the following:

(a) Enumerate (in brief) the basic principles governing an audit. (5 Marks, November, 2005)

(b) While examining the going concern assumption of an entity, what important indications should be evaluated and examined? (6 Marks, November, 2005)

Answer

(a) Basic Principles Governing an Audit: The basic principles which govern the auditor's professional responsibilities and which should be complied with wherever an audit is carried are described below:

(i) **Integrity, Objectivity and Independence:** The auditor should be straightforward, honest and sincere in his approach to his professional work. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being compatible with integrity and objectivity.

(ii) **Confidentiality:** The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.

(iii) **Skills and Competence:** The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence in auditing. The auditor requires specialised skills and competence along with a continuing awareness of developments including pronouncements of the ICAI on accounting and auditing matters, and relevant regulations and statutory requirements.

(iv) **Work performed by others:** When the auditor delegates work to assistants or uses work performed by other auditor and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied.

(v) **Documentation:** The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.

(vi) **Planning:** The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on a knowledge of the client's business.

(vii) **Audit evidence:** The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.

(viii) **Accounting System and Internal Control:** The auditor should gain an understanding of the accounting system and related controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

(ix) **Audit conclusions and reporting**: The auditor should review and assess the conclusions drawn from the audit evidence obtain and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.

The audit report should contain a clear written opinion on the financial information and should comply the legal requirements. When a qualified opinion, adverse opinion or a disclaimer of opinion is to be given or reservation of opinion on any matter is to be made, the audit report should state the reasons therefore.

(**Note**: Student may note that at present, there is no specific standard namely basic principles governing an audit. However, there are certain fundamental principles which are ethically required as per Code of Ethics read with SA 200 and SA 220. But in general abovementioned principles are basic principles only).

(b) Evaluating Going Concern Assumption: SA 570 "Going Concern", requires that while planning a performing audit procedure and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements. In assessing such a risk, the auditor should examine the following indications-

Financial Indications

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by trade payables.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay trade payables on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating Indications

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labour difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other Indications

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

Question 34

The Managing Director of the Company has committed a "Teeming and Lading" Fraud. The amount involved has been however subsequently after the year end deposited in the company. As a Statutory Auditor, how would you deal? (4 Marks, May, 2005)

Answer

Fraud Committed by Managing Director: The Managing Director of the company has committed a "Teeming and Lading" fraud. The fact that the amount involved has been subsequently deposited after the year end is not important because the auditor is required to perform his responsibilities as laid down in SA 240, "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements". First of all, as per SA 240, the auditor needs to perform procedures whether the financial statements are materially misstated. Because an instance of fraud cannot be considered as an isolated occurrence and it becomes important for the auditor to perform audit procedures and revise the audit risk assessment. Secondly, the auditor needs to consider the impact of fraud on financial statements and its disclosure in the audit report. Thirdly, the auditor should communicate the matter to the Chairman and Board of Directors. Finally, in view of the fact that the fraud has been committed at the highest level of management, it affects the reliability of audit evidence previously obtained since there is a genuine doubt about representations of management.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 35

While compiling the financial statements of a concern, you observed that the input information supplied by the concern is incomplete, incorrect and few of the Accounting Standards have not been followed. Describe, in brief, the procedure you will follow in the above.

(5 Marks, May, 2005)

Answer

Compilation of Financial Information: According to SRS 4410 "Engagements to Compile Financial Information", an accountant would normally have to rely upon the management for information to compile the financial statements in a compilation engagement. If in the course of compilation of financial statements, it is observed that the information supplied by the entity is incorrect, incomplete or otherwise unsatisfactory, the accountant should perform following procedures:

(i) Make any enquiries of management to assess the reliability and completeness of the information provided;

(ii) Assess internal controls prevailing in the entity; and

(iii) Verify any matters or explanations.

The accountant may also request the management to provide additional information. This may be asked in the form of management representation letter. If the management refuses to provide additional information, the accountant should withdraw from the engagement, informing the entity of the reasons for such withdrawal.

If one or more accounting standards are not complied with, the same should be brought to the notice of the management and if the same is not rectified by the management, the accountant should include the same in notes to the accounts and the compilation report to the management.

Question 36

Obtaining audit evidence in performing compliance and substantive procedures. Comment.

(10 Marks, May, 2005)

Answer

Obtaining Audit Evidence: As per SA 500 "Audit Evidence", in performing compliance and substantive procedures, the auditor may obtain audit evidence by following methods-

(i) **Inspection:** Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees

of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

(ii) **Observation:** Observation consists of looking at a process **or** procedure being performed by the others. For example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

(iii) **External Confirmation:** An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition.

(iv) **Recalculation:** Recalculation consists of checking the arithmetical accuracy of documents or records. Recalculation may be performed manually or electronically.

(v) **Reperformance**: It involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

(vi) **Analytical Procedure**: Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

(vii) **Inquiry:** Inquiry consists of seeking information of knowledgeable persons, both financial and non- financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Question 37

An auditor of Sagar Ltd. was not able to get the confirmation about the existence and value of certain machineries. However, the management gave him a certificate to prove the existence and value of the machinery as appearing in the books of account. The auditor accepted the same without any further procedure and signed the audit report. Is he right in his approach?

(5 Marks, November, 2004)

Answer

Validity of Management Representation: 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 Sagar 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.

Question 38

(a) What are 'Initial Audit Engagements'? (2 Marks, November, 2004)

(b) In an initial audit engagement the auditor will have 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. Lay down the audit procedure, you will follow in cases (i) when the financial statements are audited for the preceding period by another auditor; and (ii) when financial statements are audited for the first time. (7 Marks, November, 2004)

(c) If, after performing the procedure, you are not satisfied about the correctness of 'Opening Balances'; what approach you will adopt in drafting your audit report in two situations mentioned in (b) above? (7 Marks, November, 2004)

Answer

(a) Initial Audit Engagement: 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.

(b) (i) **Financial Statements Audited by another Auditor – Audit Procedure:** 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

(ii) **Audit of Financial Statements for the First Time – Audit Procedure:** When the audit of financial statements is being conducted for the first time, the auditor has to perform auditing procedures to obtain sufficient appropriate audit evidence. Since opening balances represent effect of transaction and events of the preceding period and accounting policies applied in the preceding period, the auditor need to obtain evidence having regard to nature of opening balances, materiality of the opening balances and accounting policies. Since it will not be possible for auditor to perform certain procedures, e.g., observing physical verification of inventories, etc. the auditor may obtain confirmation, etc. and perform suitable procedures in respect of fixed assets, investments, etc. The auditor can also obtain management representation with regards to the opening balances.

(c) Drafting Audit Report: 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

Question 39

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

(a) National Tourism Ltd., a wholly owned Government Company approaches you to give a revised report on the revised accounts, as the original accounts has undergone changes consequent to the audit of Comptroller and Auditor General of India.

(b) M/s LNK's group gratuity scheme's valuation by actuary shows wide variation compared to the previous year's figures. (4 Marks each, May, 2004)

Answer

(a) Auditor's Report on Revised Accounts: The Guidance Note on Auditor's Report on Revised Accounts of Companies Before Circulation to Shareholders deals with those situations wherein the statutory auditor is required to give report on the revised accounts. The auditors of National Tourism Ltd. have been asked to give revised report on the revised accounts as the original accounts have undergone changes consequent to audit of the C&AG. The Guidance Note requires that the statutory auditor must observe the following steps while issuing the revised report:

(i) All copies of the original accounts and reports thereon are returned to the auditor.

(ii) The adequate disclosure has to be made that the accounts which were earlier approved by the Board of Directors and reported by the auditors have been revised and re-approved by the Board of Directors as a specific note on the amended accounts.

(iii) In case the notes to accounts do not contain any note on revision or such a note is not considered adequate or comprehensive, the statutory auditor shall have to indicate that accounts have been revised based on the audit report of C&AG. The auditors at the time of issue of revised report has to bring these facts in his report if not included as a note in the revised accounts.

(v) Finally, the auditor's report (revised) should clearly draw the attention to their earlier audit report.

Note : Section 131 of the Companies Act, 2013 prescribes the voluntary revisions of the financial statements or Board's report which is yet to be notified.

(b) Valuation by Actuary: As per SA 620 "Using the Work of an Auditor's Expert", an evaluation of the work of an expert can be done considering the following facts-

(i) When the auditor plans to use the expert's work as audit evidence, he should satisfy himself as to the expert's skills and competence by considering the expert's:

(1) professional qualifications, license or membership in an appropriate professional body, and

(2) experience and reputation in the field in which the evidence is sought.

(ii) The objectives and scope of the experts' work.

(iii) A general outline as to specific items in the expert's report.

(iv) Confidentiality of the client's information used by the expert.

(v) The source data used.

(vi) The assumptions and methods used and, if appropriate, their comparison with the prior period.

(vii) The results of the expert's work in the light of auditor's overall knowledge of the business and of the results of his audit procedures.

(viii) The auditor should also satisfy himself that the substance of the expert's findings is properly reflected in the financial statements.

(ix) Consider whether the expert has used the appropriate source data, by making inquiries of the expert.

(x) Conducting audit procedures on the data by the client to the expert to obtain reasonable assurance that the data are appropriate.

The auditor has to evaluate the work of an expert, say, actuary, before adopting the same. This becomes more crucial since M/s LNK's group gratuity scheme's valuation by actuary shows wide variation compared to previous year figures. There is no doubt that appropriateness, reasonableness of assumptions and methods used are the responsibility of the expert, but the auditor has to determine whether they are reasonable based on the auditor's knowledge of the client's business and result of his audit procedures. In the present case, the auditor must verify the reasonableness of assumptions made and methods adopted by the actuary in the evaluation particularly with reference to factors such as rate of return on investments, retirement age, number and salary of employees, etc. Accordingly, the auditor has to satisfy himself whether valuation done by the actuary can be adopted, otherwise he may report on his findings for wide variation.

2

Audit Strategy, Planning and Programming

Question 1

You have been appointed as the statutory auditor of a private limited company for the first time. Apart from adopting the conventional audit procedures such as posting, casting and vouching, what other auditing techniques would you employ for conducting the statutory audit?

Answer

A statutory auditor conducting audit of a private company for the first time would do well in case he obtains knowledge of the business of the company to understand and assess the kind of audit procedures to be employed by him as per 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" respectively. 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:

(i) Assessing risks and identifying problems.

(ii) Planning and performing the audit effectively and efficiently.

(iii) Evaluating audit evidence.

Such knowledge would 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. As far as adoption of conventional audit procedures is concerned, it would normally involve lot of time without commensurate benefits. In any case, if size of the business is large, the application of conventional procedure would involve extraordinary more time resulting into more cost and even then the auditor would not get the required satisfaction as to the figures contained in the financial statements. There may however, be some instances, say, where internal control systems are quite weak, it may perhaps be advisable to stick to conventional audit procedures such as vouching, etc. in detail. In any case, application of compliance procedure to evaluate the internal control systems in operations would enable the auditor to determine nature, extent and timing of substantive procedures.

Depending upon various factors including size of the business, it is advisable to reduce the extent of checking by adopting test check approach. Test-check approach is an accepted auditing procedure, which aims to test transactions on the basis of selection of samples from the entire population. Audit sampling means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population. It is important to recognise that certain testing procedures do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve sampling. Likewise, applying audit procedures to all items within a population which have a particular characteristic (for example, all items over a certain amount) does not qualify as audit sampling with respect to the portion of the population examined, nor with regard to the population as a whole, since the items were not selected from the total population on a basis that was expected to be representative. Such items might imply some characteristic of the remaining portion of the population. The auditor would also consider the specific audit objectives to be achieved and the audit procedures which are likely to best achieve those objectives. In addition, when audit sampling is appropriate, consideration of the nature of the audit evidence sought and possible error conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes an error and what population to use for sampling. For example, when performing tests of control over an entity's purchasing procedures, the auditor will be concerned with matters such as whether an invoice was clerically checked and properly approved. On the other hand, when performing substantive procedures on invoices processed during the period, the auditor will be concerned with matters such as the proper reflection of the monetary amounts of such invoices in the financial statements.

After performing vouching, it is necessary for an auditor to perform verification of balances contained in the financial statements. Verification and valuation of assets and liabilities contained in the balance sheet would involve obtaining evidence through methods like physical observations, confirmation, computation, inspection of documents and analytical reviews. Direct confirmation procedure provides an independent audit evidence to analyse the financial information contained in the accounting records. For example, confirmation may be done for trade receivables, trade payables, investments lying with third parties, bank balances, etc.

Apart from conducting audit procedures like vouching and verification, it is quite useful to employ analytical review procedures; In fact, analytical review procedures would provide substantive audit evidence to support various assertions in the financial statements. Over a period of time, the analytical review as a method of obtaining evidence has emerged as a significant auditing procedures. As per SA 520, analytical procedures means the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts. Analytical procedures in planning the audit use both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold. The auditor's reliance on substantive procedures to

reduce detection risk relating to specific financial statement assertions may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedures to use to achieve a particular audit objective is based on the auditor's judgement about the expected effectiveness and efficiency of the available procedures in reducing detection risk for specific financial statement assertions. It further states that when analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative evidence.

Therefore, a statutory auditor who has been appointed for the first time must resort to evaluation of internal control system through performance of compliance procedures based on the knowledge of the client's business followed by vouching on a selected basis having regard to sampling. Physical observation and direct confirmation are also useful audit techniques in the verification of items contained in the financial statements. Ratio analysis or analytical procedures would also provide audit evidence as to various assertions contained in the financial statements.

Question 2

Write short notes on the following:

(a) Walk through Tests

(b) Cut-off Procedures.

Answer

(a) Walk through Tests: A walk through is a procedure in which an auditor traces a transaction from its initiation through the company's information systems to the point when it is reflected in the financial reports. The auditor should perform one walk through, at a minimum, for each major class of transactions. A walk-through provides evidence to confirm that the auditor understands (1) the process flow of transactions, (2) the design of identified controls for internal control components, including those related to preventing and detecting fraud, and (3) whether all points in the process have been identified at which misstatements related to relevant financial statement assertion could occur. Walk through also provide evidence to evaluate the effectiveness of the controls' design and confirm that the controls have been placed in operation.

When performing a walk-through, the auditor should:

(i) Be sure that the walk-through encompasses the complete process (initiation, authorization, recording, processing and reporting) for each significant process identified, including controls intended to address fraud risk.

(ii) Ask the entity's personnel, at each of key stage in the process, about their understanding of what the company's prescribed procedures require.

(iii) Determine whether processing procedures are performed as expected on a timely basis, and look for any exceptions to prescribed procedures and controls.

(iv) Evaluate the quality of evidence provided and perform procedures that produce a level of evidence consistent with the auditor's objectives. The auditor should follow the whole process, using the same documents and technology that company staff use, asking questions of different personnel at each significant stage and asking follow- up questions to identify any abuse of controls or fraud indicators.

Once a walk-through is performed, the auditor may carry forward the documentation, noting updates, unless significant changes make preparation of new documentation more efficient. If such significant changes occur in the process flow of transactions or supporting computer applications, the auditor should evaluate the nature of changes and the effect on related accounts. The auditor should determine whether it is necessary to walk through transactions that were processed both before and after the change.

(b) Cut-off Procedures: Cut-off procedures mean procedures employed to ensure the separation of transactions at the end of one year from those in the commencement of the next year. Usually, the problem of overlapping is found in inventory accounting since quite often goods are sold but passed on to the buyer only after the year is over or goods are bought but received only after the close of the year. This situation may create considerable problem for the proper stock taking of inventory. Therefore, the principal areas of application of cut-off procedures involve sales, purchases and stock. The auditor should satisfy himself by examination and test check that these procedures adequately ensure that:

(i) Goods purchased for which property has passed to the client have in fact been included in inventories and that the liability if any, has been provided for.

(ii) Goods sold have been excluded from the inventories and credit has been taken for sales.

The auditor may examine a sample of documents evidencing the movement of stocks into and out of stores, including documents pertaining to period shortly before and shortly after the cut-off date, and check whether the stocks represented by those documents were included or excluded, as appropriate, during the stock-taking.

Question 3

Designing an Audit Strategy is the backbone of the "Audit Planning" process. Discuss.

Answer

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" respectively 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:

   (a) considering the results of gathering or updating information about the client; and

   (b) 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.

Question 4

As a chartered accountants firm draft an engagement letter to the Board of Directors for the compilation of financial statements of XYZ Ltd. as at 31.3.20XX.

Answer

Engagement letter to the Board of Directors for the compilation of financial statements of XYZ Ltd. as at 31.3.20XX

To

The Board of Directors
XYZ Ltd.
……

You have vide your letter dated ……..requested that we compile the Balance Sheet of XYZ. Ltd. as at 31.3.20XX and the related Profit and Loss account for the year ended on that date.

We are pleased to confirm our acceptance and understanding of the engagement by means of this letter. As no audit or review engagement procedures would be carried out, no opinion on the financial statements will be expressed. Further, our engagement cannot be relied upon to disclose whether frauds or defalcations, or illegal acts exist. However, we will inform you of any such matters which might come to our attention in the course of the engagement.

As Management, you are responsible for:

(a) The accuracy and completeness of the information supplied to us, including maintenance of adequate accounting records and internal controls and selection and application of appropriate accounting policies.

(b) Preparation and presentation of the financial statements of the entity, in accordance with the applicable laws and regulations, if any.

(c) Safeguarding the assets of the entity and also establishing appropriate controls designed to prevent and detect fraud and other irregularities.

(d) Ensuring that the activities of the entity are carried on in accordance with applicable laws and regulations and that it institutes appropriate controls to prevent and detect any non-compliance.

You will confirm that events and transactions are recorded in accordance with the applicable accounting standard(s), issued by the Institute of Chartered Accountants of India and other recognized accounting principles and practices and inform us of any departures therefrom.

As part of our normal procedures, we may request you to provide written confirmations of any information or explanations given to us orally during the course of our work.

We understand that the intended use and distribution of the information we have compiled is …… (specify purpose)

We look forward to full co-operation with your staff and we trust that they will make available to us whatever records, documents and other information requested in connection with our engagement.

Our fees will be billed as the work progresses.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our compilation of your financial statements.

XYZ & Co.
Chartered Accountants
Firm Registration No.
S/d

Question 5

M/s PQR & Company, Chartered Accountants have been appointed Statutory Auditors of a listed Company for the year ended 31st March, 20XX. Draft an appropriate engagement letter to be sent to the Board of Directors for the same.

Answer

Draft of an Engagement Letter

To the Board of Directors

You have requested that we audit the balance sheet of (Name of the Company) as at 31st March, 20XX and the related profit and loss account and the cash flow statement for the year ended on that date. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the firm statements.

We will conduct our audit in accordance with the auditing standards generally accepted in India and with the requirements of the Companies Act. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

However, having regard to the test nature of an audit, persuasive rather than conclusive nature of audit evidence together with inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements of financial statements, resulting from fraud, and to a lesser extent error, if either exists, may remain undetected.

In addition to our report on the financial statements, we expect to provide you with a separate letter concerning any material weaknesses in accounting and internal control systems which might come to our notice.

The responsibility for the preparation of financial statements on a going concern basis is that of the management. The management is also responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards. The management is also responsible for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.

The responsibility of the management also includes the maintenance of adequate accounting records and internal controls for safeguarding of the assets of the company and for the preventing and detecting fraud or other irregularities. As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' under the Chartered Accountants Act, 1949. The reviewer may examine our working papers during the course of the peer review.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records; documentation and other information are requested in connection with our audit.

Our fees will be billed as the work progresses.

This letter will be effective for future years unless it is terminated, amended or superseded.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

PQR & Co.
Chartered Accountants
……
(Signature)
Firm's Registration No.
(Name of the Member)
(Designation)

Date :

Place :

Acknowledged on behalf of
_____Company by
……

(Signature)
Name and Designation
Date

Question 6

X Ltd., paid ₹ 25 lakhs as advance to Y Ltd. towards the purchase of a printing machinery on 15.1.14 with delivery instructions to deliver the same in the last week of June, 14. Further on 2.2.14 X Ltd. purchased two diesel generator sets from Y Ltd. for ₹ 30 lakhs on 90 days Credit term. In the accounts for 2013-14, X Ltd. intends to adjust the advance paid against Credit purchase and show the net amount of ₹ 5 lakhs as due from them. As the statutory auditor, how would you deal with this?

Answer

Since X Ltd. has paid advance amount to the supplier of machinery to be used in the project, such advance amount should be grouped under the head 'Capital Work in Progress'. This is as per requirement of Schedule III to the Companies Act, 2013 and the existing accounting practice.

If the advance is for purchase of other machinery, it should be grouped under a separate head – say 'Advance Payment for Capital Expenditure' and should be disclosed as next item to Fixed Assets in the Balance Sheet.

In view of the above, the proposal of X Ltd., to show the net balance in the personal account of Y Ltd., is not correct. Such proposal will conceal the two material items in the balance sheet – one, expenditure towards capital asset and the other current liability for purchase of the generator set.

Hence, the auditor should advise X Ltd., to show these two items separately. If X Ltd., does not accept the advice, the auditor should qualify his report with suitable quantification of amount involved.

Question 7

Answer the following:

(a) What are the considerations to be kept in mind while performing analytical procedures on data prepared by the client?

(b) You have been appointed as the auditor of a Multiplex Cinema House. Draw an audit programme in respect of its Revenue and Expenditure.

Answer

(a) 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.

(b) Audit Programme of Multiplex

(i) Peruse the Memorandum of Association and Articles of Association of the entity.

(ii) Ensure the object clause permits the entity to engage in this type of business.

(iii) In the case of income from sale of tickets:

(1) Verify the control system as to how it is ensured that the collections on sale of tickets of various shows are properly accounted.

(2) Verify the system of relating to online booking of various shows and the system of realization of money.

(3) Check that there is overall system of reconciliation of collections with the number of seats available for different shows on a day.

(iv) Verify the internal control system and its effectiveness relating to the income from cafe shops, pubs etc., located within the multiplex.

(v) Verify the system of control exercised relating to the income receivable from advertisements exhibited within the premises and inside the hall such as hoarding, banners, slides, short films etc.

(vi) Verify the system of collection from the parking areas in respect of the vehicles parked by the customers.

(vii) In the case of payment to the distributors verify the system of payment which may be either through out right payment or percentage of collection or a combination of both. Ensure at the time of settlement any payment of advance made to the distributor is also adjusted against the amount due.

(viii) Verify the system of payment of salaries and other benefits to the employees and ensure that statutory requirements are complied with.

(ix) Verify the payments effected in respect of the maintenance of the building and ensure the same is in order.

Question 8

What are the points to be considered while evaluating the "Knowledge of the Business" in the conduct of an audit?

Answer

The broad matters to be considered while obtaining knowledge of business for a new audit assignment are set out in SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment. These are:

(i) Relevant industry, regulatory, economic and other external factors including the applicable financial reporting framework.

(ii) The nature of the entity, including:

(1) its operations;

(2) its ownership and governance structures;

(3) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

(4) the way that the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(iii) The entity's selection and application of accounting policies.

(iv) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

(v) The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgement regarding the appropriateness of accounting policies and disclosures.

Question 9

A & Co. was appointed as auditor of Great Airways Ltd. As the audit partner what factors shall be considered in the development of overall audit plan?

Answer

Development of an overall plan - Overall plan is basically intended to provide direction for audit work programming and includes the determination of timing, manpower development and co-ordination of work with the client, other auditors and other experts. The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit:

(i) Terms of his engagement and any statutory responsibilities.

(ii) Nature and timing of reports or other communications.

(iii) Applicable Legal or Statutory requirements.

(iv) Accounting policies adopted by the clients and changes, if any, in those policies.

(v) The effects of new accounting and auditing pronouncement on the audit.

(vi) Identification of significant audit areas.

(vii) Setting of materiality levels for the audit purpose.

(viii) Conditions requiring special attention such as the possibility of material error or fraud or involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.

(ix) Degree of reliance to be placed on the accounting system and internal control.

(x) Possible rotation of emphasis on specific audit areas.

(xi) Nature and extent of audit evidence to be obtained.

(xii) Work of the internal auditors and the extent of reliance on their work, if any in the audit.

(xiii) Involvement of other auditors in the audit of subsidiaries or branches of the client and involvement of experts.

(xiv) Allocation of works to be undertaken between joint auditors and the procedures for its control and review.

(xv) Establishing and coordinating staffing requirements.

Question 10

XY Ltd. is a manufacturing company, provided following details of wastages of raw materials in percentage, for various months. You have been asked to enquire into causes of abnormal wastage of raw materials. Draw out an audit plan.

Wastage percentage are	
July 2014	*1.5%*
Aug 2014	*1.7%*
Sep 2014	*1.4%*
Oct 2014	*4.1%*

Answer

Audit Plan to locate the Abnormal Wastage of Raw Material: To locate the reasons for the abnormal wastage, the auditor should first of all assess the general requirements as under:

(i) Procure a list of raw materials, showing the names and detailed characteristics of each raw material.

(ii) Obtain the standard consumption figures, and ascertain the basis according to which normal wastage figures have been worked out. Examine the break-up of a normal wastage into that in process, storage and handling stages. Also obtain control reports, if any, in respect of manufacturing costs with reference to predetermined standards.

(iii) Examine the various records maintained for recording separately the various lots purchased and identification of each lot with actual material consumption and for ascertaining actual wastage figures therein.

(iv) Obtain reports of Preventive Maintenance Programme of machinery to ensure that the quality of goods manufacture is not of sub-standard nature or leads to high scrappage work.

(v) Assess whether personnel employed are properly trained and working efficiently.

(vi) See whether quality control techniques have been consistent or have undergone any change.

(vii) Examine inventory plans and procedures in report of transportation storage efficiency, deterioration, pilferage and whether the same are audited regularly.

(viii) Examine whether the basis adopted for calculating wastage for September is the same as was adopted for the other three months.

(ix) Obtain a statement showing break up of wastage figures in storage, handling and process for the four months under reference and compare the results of the analysis for each of the four months.

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

(i) Examine laboratory reports and inspection reports to find out if raw materials purchased were of a poor quality or were of sub-standard quality. This will be most useful if it is possible to identify the wastage out of each lot that has been purchased.

(ii) Machine breakdown, power failure, etc. may also result into loss of materials in process. Check the machine utilisation statements.

(iii) A high rate of rejections in the finished lots may also be responsible for abnormal wastage; therefore, examine the inspectors' reports in respect of inspection carried out on the completion of each stage of work or process.

(iv) It is possible that the wastage may have occurred because the particular lot out of which issues were made was lying in the store for a long time, leading to deterioration in quality or because of a change in the weather which may have led to the deterioration. Compare the wastage figures.

(v) Abnormal wastage in storage and handling may arise due to the following reasons:

(1) Write offs on account of reconciliation of physical and book inventories: In case of periodical physical inventory taking, such write offs will be reflected only in the month such reconciliation takes place.

(2) Accidental, theft or fire losses in storage: The auditor should examine the possibility of these for the purpose.

(vi) Examine whether any new production line was taken up during the month in respect of which standard input-output ratio is yet to be set-up.

Question 11

(a) What are general matters to be considered by an auditor while taking up an engagement?

(b) What are the major sources of obtaining information about the client's business?

Answer

(a) General matters to be considered while taking up a new engagement:

General Economic factors: General level of economic activity (for example, recession, growth)

(i) The market and competition.

(ii) Cyclical or seasonal activity.

(iii) Government policies.

The industry- important conditions affecting the client's business

(i) The market and competitions.

(ii) Cyclical or seasonal activity.

(iii) Changes in product technology.

(iv) Business risk.

The entity:

(i) Management and ownership- important characteristics.

(ii) Operating Management.

(iii) The entity's business – products markets, suppliers, expenses, operations.

(1) Nature of business(es) (for example manufacturing whole seller, financial

services, import/ exports).

(2) Location of production facilities, warehouses, offices.

(3) Employment (for example, by location, supply, wage levels, union contracts, pension commitments, Government regulation).

(4) Products or services and markets.

(iv) Financial performance– factors concerning the entity's financial condition and profitability.

(v) Reporting environment- external influences which affect management in the preparation of the financial statements.

(vi) Legislation:

(1) Regulatory environment and requirements.

(2) Taxation both direct and indirect.

(b) Information about the client's business: The auditor can obtain information about client's business from the following sources:

(i) The client's annual Reports to shareholders;

(ii) Minutes of meetings of shareholders, board of directors and important committees;

(iii) Internal financial management report for current and previous periods, including budgets, if any;

(iv) The previous year's audit working papers, and other relevant files;

(v) Firm personnel responsible for non audit services to the client who may be able to provide information on matters that may affect the audit;

(vi) Discussions with the client;

(vii) The client's policy and procedures manual;

(viii) Relevant publications of the Institute of Chartered Accountants of India and other professional bodies, industry publication, trade Journals, magazines, newspapers or text books;

(ix) Consideration of the state of the economy and its effects on the client's business;

(x) Visits to the client's premises and plant facilities to the management.

Question 12

As an internal auditor of a Cement Manufacturing Company, draft an audit programme for verification of transportation charges for dispatches from the factory.

Answer

Procedure for Audit of Transportation Charges:

(i) Check rates contracted with transporters for carriage of goods.

(ii) Check whether the rates mentioned as per the contract are correctly taken in the transporter's Invoice.

(iii) In case of discrepancy, check whether the same is authorized by the appropriate sanctioning authority.

(iv) Check that the transporter's invoice includes a delivery challan which has customers stamp indicating the receipt of goods.

(v) In case there is no stamp on the delivery challan, check whether the goods are received back and there is a corresponding inward note.

(vi) Check whether all the goods to be dispatched have a transport booking order reference.

(vii) Check whether each transporter's invoice mentions the transport booking order reference.

(viii) Check whether all the transport booking orders have corresponding transporters names.

(ix) Check whether the transport booking orders are pre-numbered.

(x) Check whether all the invoices are correctly booked in the books of accounts.

(xi) In case there is an additional charge by the transporter due to extra carriage, check for the relevant supporting (like material Inward Note/Customer Rejection Note) and necessary authorization by the sanctioning authority.

(xii) Check whether service-tax on the transporters is correctly calculated and accounted.

(xiii) Verify that there is a mechanism for linking all the Transport Bills to the sale invoices.

Question 13

As an internal auditor for a large manufacturing concern, you are asked to verify whether there are adequate records for identification and value of Plant and Machinery, tools and dies and whether any of these items have become obsolescent and not in use. Draft a suitable audit programme for the above.

Answer

The Internal Audit Programme in connection with Plant and Machinery and Tools and dies may be on the following lines:

(i) Internal Control Aspects: The following may be incorporated in the audit programme to check the internal control aspects-

(a) Maintaining separate register for hired assets, leased asset and jointly owned assets.

(b) Maintaining register of fixed asset and reconciling to physical inspection of fixed asset and to nominal ledger.

(c) All movements of assets are accurately recorded.

(d) Authorisation be obtained for –

(1) a declaring a fixed asset scrapped.

(2) selling a fixed asset.

(e) Check whether additions to fixed asset register are verified and checked by authorised person.

(f) Proper recording of all additions and disposal.

(g) Examining procedure for the purchase of new fixed assets, including written authority, work order, voucher and other relevant evidence.

(h) Regular review of adequate security arrangements.

(i) Periodic inspection of assets is done or not.

(j) Regular review of insurance cover requirements over fixed assets.

(ii) Assets Register: To review the registers and records of plant, machinery, etc. showing clearly the date of purchase of assets, cost price, location, depreciation charged, etc.

(iii) Cost Report and Journal Register: To review the cost relating to each plant and machinery and to verify items which have been capitalised.

(iv) Code Register: To see that each item of plant and machinery has been given a distinct code number to facilitate identification and verify the maintenance of Code Register.

(v) Physical Verification: To see physical verification has been conducted at frequent intervals.

(vi) Movement Register: To verify (a) whether a Movement Register for movable equipments and (b) log books in case of vehicles, etc. are being maintained properly.

(vii) Assets Disposal Register: To review whether assets have been disposed off after proper technical and financial advice and sales/disposal/retirement, etc. of these assets are governed by authorisation, sales memos or other appropriate documents.

(viii) Spare Parts Register: To examine the maintenance of a separate register of tools, spare parts for each plant and machinery.

(ix) Review of Maintenance: To scrutinise the programme for an actual periodical servicing and overhauling of machines and to examine the extent of utilisation of maintenance department services.

(x) Review of Obsolescence: To scrutinise whether expert's opinion have been obtained from time to time to ensure purchase of technically most useful efficient and advanced machinery after a thorough study.

(xi) Review of R&D: To review R&D activity and ascertain the extent of its relevance to the operations of the organisation, maintenance of machinery efficiency and prevention of early obsolescence.

2

Audit Strategy, Planning and Programming

Question 1

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

Draw out an audit plan.

Wastage percentage are

July 2010	*1.5%*	
Aug 2010	*1.7%*	
Sep 2010	*1.4%*	
Oct 2010	*4.1%.*	*(8 Marks, November, 2011)*

Answer

Audit Plan to locate the Abnormal Wastage of Raw Material: To locate the reasons for the abnormal wastage, the auditor should first of all assess the general requirements as under:

(i) Procure a list of raw materials, showing the names and detailed characteristics of each raw material.

(ii) Obtain the standard consumption figures, and ascertain the basis according to which normal wastage figures have been worked out. Examine the break-up of a normal wastage into that in process, storage and handling stages. Also obtain control reports, if any, in respect of manufacturing costs with reference to predetermined standards.

(iii) Examine the various records maintained for recording separately the various lots purchased and identification of each lot with actual material consumption and for ascertaining actual wastage figures therein.

(iv) Obtain reports of Preventive Maintenance Programme of machinery to ensure that the quality of goods manufacture is not of sub-standard nature or leads to high scrappage work.

(v) Assess whether personnel employed are properly trained and working efficiently.

(vi) See whether quality control techniques have been consistent or have undergone any change.

(vii) Examine inventory plans and procedures in report of transportation storage efficiency, deterioration, pilferage and whether the same are audited regularly.

(viii) Examine whether the basis adopted for calculating wastage for September is the same as was adopted for the other three months.

(ix) Obtain a statement showing break up of wastage figures in storage, handling and process for the four months under reference and compare the results of the analysis for each of the four months.

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

(i) Examine laboratory reports and inspection reports to find out if raw materials purchased were of a poor quality or were of sub-standard quality. This will be most useful if it is possible to identify the wastage out of each lot that has been purchased.

(ii) Machine breakdown, power failure, etc. may also result into loss of materials in process. Check the machine utilisation statements.

(iii) A high rate of rejections in the finished lots may also be responsible for abnormal wastage; therefore, examine the inspectors' reports in respect of inspection carried out on the completion of each stage of work or process.

(iv) It is possible that the wastage may have occurred because the particular lot out of which issues were made was lying in the store for a long time, leading to deterioration in quality or because of a change in the weather which may have led to the deterioration. Compare the wastage figures.

(v) Abnormal wastage in storage and handling may arise due to the following reasons:

  (1) Write offs on account of reconciliation of physical and book stocks: In case of periodical physical stock taking, such write offs will be reflected only in the month such reconciliation takes place.

  (2) Accidental, theft or fire losses in storage: The auditor should examine the possibility of these for the purpose.

(vi) Examine whether any new production line was taken up during the month in respect of which standard input-output ratio is yet to be set-up.

Question 2

A & Co. was appointed as auditor of Great Airways Ltd. As the audit partner what factors shall be considered in the development of overall audit plan? (8 Marks, May, 2011)

Answer

Development of an overall plan - Overall plan is basically intended to provide direction for audit work programming and includes the determination of timing, manpower development and

co-ordination of work with the client, other auditors and other experts. The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit.

(i) Terms of his engagement and any statutory responsibilities.

(ii) Nature and timing of reports or other communications.

(iii) Applicable Legal or Statutory requirements.

(iv) Accounting policies adopted by the clients and changes, if any, in those policies.

(v) The effects of new accounting and auditing pronouncement on the audit.

(vi) Identification of significant audit areas.

(vii) Setting of materiality levels for the audit purpose.

(viii) Conditions requiring special attention such as the possibility of material error or fraud or involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.

(ix) Degree of reliance to be placed on the accounting system and internal control.

(x) Possible rotation of emphasis on specific audit areas.

(xi) Nature and extent of audit evidence to be obtained.

(xii) Work of the internal auditors and the extent of reliance on their work, if any in the audit.

(xiii) Involvement of other auditors in the audit of subsidiaries or branches of the client and involvement of experts.

(xiv) Allocation of works to be undertaken between joint auditors and the procedures for its control and review.

(xv) Establishing and coordinating staffing requirements.

Question 3

What are the points to be considered while evaluating the "Knowledge of the Business" in the conduct of an audit? (8 Marks, June, 2009)

Answer

The broad matters to be considered while obtaining knowledge of business for a new audit assignment are set out in SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment. These are:

(i) Relevant industry, regulatory, economic and other external factors including the applicable financial reporting framework.

(ii) The nature of the entity, including:

  (a) its operations;

  (b) its ownership and governance structures;

  (c) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

  (d) the way that the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(iii) The entity's selection and application of accounting policies.

(iv) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

(v) The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgement regarding the appropriateness of accounting policies and disclosures.

Question 4

You have been appointed as the auditor of a Multiplex Cinema House. Draw an audit programme in respect of its Revenue and Expenditure. (8 Marks, November, 2009)

Answer

Audit Programme of Multiplex

(i) Peruse the Memorandum of Association and Articles of Association of the entity.

(ii) Ensure the object clause permits the entity to engage in this type of business.

(iii) In the case of income from sale of tickets:

  (a) Verify the control system as to how it is ensured that the collections on sale of tickets of various shows are properly accounted.

  (b) Verify the system of relating to online booking of various shows and the system of realization of money.

  (c) Check that there is overall system of reconciliation of collections with the number of seats available for different shows on a day.

(iv) Verify the internal control system and its effectiveness relating to the income from cafe shops, pubs etc., located within the multiplex.

(v) Verify the system of control exercised relating to the income receivable from advertisements exhibited within the premises and inside the hall such as hoarding, banners, slides, short films etc.

(vi) Verify the system of collection from the parking areas in respect of the vehicles parked by the customers.

(vii) In the case of payment to the distributors verify the system of payment which may be either through out right payment or percentage of collection or a combination of both.

Ensure at the time of settlement any payment of advance made to the distributor is also adjusted against the amount due.

(viii) Verify the system of payment of salaries and other benefits to the employees and ensure that statutory requirements are complied with.

(ix) Verify the payments effected in respect of the maintenance of the building and ensure the same is in order.

Question 5

M/s PQR & Company, Chartered Accountants have been appointed Statutory Auditors of a listed Company for the year ended 31st March, 2008. Draft an appropriate engagement letter to be sent to the Board of Directors for the same. (12 Marks, November, 2007)

Answer

Draft of an Engagement Letter:

To the Board of Directors

You have requested that we audit the balance sheet of (Name of the Company) as at 31st March, 20XX and the related profit and loss account and the cash flow statement for the year ended on that date. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the firm statements.

We will conduct our audit in accordance with the auditing standards generally accepted in India and with the requirements of the Companies Act. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

However, having regard to the test nature of an audit, persuasive rather than conclusive nature of audit evidence together with inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements of financial statements, resulting from fraud, and to a lesser extent error, if either exists, may remain undetected.

In addition to our report on the financial statements, we expect to provide you with a separate letter concerning any material weaknesses in accounting and internal control systems which might come to our notice.

The responsibility for the preparation of financial statements on a going concern basis is that of the management. The management is also responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards. The management is also responsible for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.

The responsibility of the management also includes the maintenance of adequate accounting records and internal controls for safeguarding of the assets of the company and for the preventing and detecting fraud or other irregularities. As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' under the Chartered Accountants Act, 1949. The reviewer may examine our working papers during the course of the peer review.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records; documentation and other information are requested in connection with our audit.

Our fees will be billed as the work progresses.

This letter will be effective for future years unless it is terminated, amended or superseded.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

PQR & Co.
Chartered Accountants
……

(Signature)

Firm's Registration No.

(Name of the Member)

(Designation)

Date :

Place :

Acknowledged on behalf of
_____Company by
……

(Signature)
Name and Designation
Date

Question 6

As a chartered accountants firm draft an engagement letter to the Board of Directors for the compilation of financial statements of XYZ Ltd. as at 31.3.2007. (16 Marks, May, 2007)

Answer

Engagement letter to the Board of Directors for the compilation of financial statements of XYZ Ltd. as at 31.3.2007:

To

The Board of Directors
XYZ Ltd.
……

You have vide your letter dated ……requested that we compile the Balance Sheet of XYZ. Ltd. as at 31.3.20XX and the related Profit and Loss account for the year ended on that date.

We are pleased to confirm our acceptance and understanding of the engagement by means of this letter. As no audit or review engagement procedures would be carried out, no opinion on the financial statements will be expressed. Further, our engagement cannot be relied upon to disclose whether frauds or defalcations, or illegal acts exist. However, we will inform you of any such matters which might come to our attention in the course of the engagement.

As Management, you are responsible for :

(a) The accuracy and completeness of the information supplied to us, including maintenance of adequate accounting records and internal controls and selection and application of appropriate accounting policies.

(b) Preparation and presentation of the financial statements of the entity, in accordance with the applicable laws and regulations, if any.

(c) Safeguarding the assets of the entity and also establishing appropriate controls designed to prevent and detect fraud and other irregularities.

(d) Ensuring that the activities of the entity are carried on in accordance with applicable laws and regulations and that it institutes appropriate controls to prevent and detect any non-compliance.

You will confirm that events and transactions are recorded in accordance with the applicable accounting standard(s), issued by the Institute of Chartered Accountants of India and other recognized accounting principles and practices and inform us of any departures therefrom.

As part of our normal procedures, we may request you to provide written confirmations of any information or explanations given to us orally during the course of our work.

We understand that the intended use and distribution of the information we have compiled is (specify purpose)

We look forward to full co-operation with your staff and we trust that they will make available to us whatever records, documents and other information requested in connection with our engagement.

Our fees will be billed as the work progresses.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our compilation of your financial statements.

XYZ & Co.
Chartered Accountants
Firm Registration No.

S/d

Question 7

Write short notes on Analytical procedures in planning an audit. *(4 Marks, May, 2007)*

Answer

Analytical procedures in planning an audit: In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures.

Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, the square feet of selling space, volume of goods produced and similar information.

Question 8

(a) What are general matters to be considered by an auditor while taking up a engagement?

(b) What are the major sources of obtaining information about the client's business?

(4 Marks each, November, 2006)

Answer

(a) General matters to be considered while taking up a new engagement:

General Economic factors: General level of economic activity (for example, recession, growth)

(i) The market and competition.

(ii) Cyclical or seasonal activity

(iii) Government policies

The industry: Important conditions affecting the client's business

(i) The market and competitions

(ii) Cyclical or seasonal activity

(iii) Changes in product technology

(iv) Business risk

The entity:

(i) Management and ownership- important characteristics

(ii) Operating Management

(iii) The entity's business – products markets, suppliers, expenses, operations.

  (1) Nature of business(es) (for example manufacturing whole seller, financial services, import/ exports)

  (2) Location of production facilities, warehouses, offices.

  (3) Employment (for example, by location, supply, wage levels, union contracts, pension commitments, Government regulation)

  (4) Products or services and markets.

(iv) Financial performance– factors concerning the entity's financial condition and profitability.

(v) Reporting environment- external influences which affect management in the preparation of the financial statements.

(vi) Legislation:

  (1) Regulatory environment and requirements

  (2) Taxation both direct and indirect.

(b) Information about the client's business: The auditor can obtain information about client's business from the following sources:

(i) The client's annual Reports to shareholders;

(ii) Minutes of meetings of shareholders, board of directors and important committees;

(iii) Internal financial management report for current and previous periods, including budgets, if any;

(iv) The previous year's audit working papers, and other relevant files;

(v) Firm personnel responsible for non audit services to the client who may be able to provide information on matters that may affect the audit;

(vi) Discussions with the client;

(vii) The client's policy and procedures manual;

(viii) Relevant publications of the Institute of Chartered Accountants of India and other professional bodies, industry publication, trade Journals, magazines, newspapers or text books;

(ix) Consideration of the state of the economy and its effects on the client's business;

(x) Visits to the client's premises and plant facilities to the management.

Question 9

Designing an Audit Strategy is the backbone of the "Audit Planning" process. Discuss.

(10 Marks, May, 2006)

Answer

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:

(a) considering the results of gathering or updating information about the client; and

(b) 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.

Question 10

As an internal auditor of a Cement Manufacturing Company, draft an audit programme for verification of transportation charges for despatches from the factory. (8 Marks, May, 2006)

Answer

Procedure for Audit of Transportation Charges

(i) Check rates contracted with transporters for carriage of goods.

(ii) Check whether the rates mentioned as per the contract are correctly taken in the transporter's Invoice.

(iii) In case of discrepancy, check whether the same is authorized by the appropriate sanctioning authority.

(iv) Check that the transporter's invoice includes a delivery challan which has customers stamp indicating the receipt of goods.

(v) In case there is no stamp on the delivery challan, check whether the goods are received back and there is a corresponding inward note.

(vi) Check whether all the goods to be dispatched have a transport booking order reference.

(vii) Check whether each transporter's invoice mentions the transport booking order reference.

(viii) Check whether all the transport booking orders have corresponding transporters names.

(ix) Check whether the transport booking orders are pre-numbered.

(x) Check whether all the invoices are correctly booked in the books of accounts.

(xi) In case there is an additional charge by the transporter due to extra carriage, check for the relevant supporting (like material Inward Note/Customer Rejection Note) and necessary authorization by the sanctioning authority.

(xii) Check whether service-tax on the transporters is correctly calculated and accounted.

(xiii) Verify that there is a mechanism for linking all the Transport Bills to the sale invoices.

Question 11

As an internal auditor for a large manufacturing concern, you are asked to verify whether there are adequate records for identification and value of Plant and Machinery, tools and dies and whether any of these items have become obsolescent and not in use. Draft a suitable audit programme for the above. (10 Marks, May, 2005)

Answer

The Internal Audit Programme in connection with Plant and Machinery and Tools and dies may be on the following lines:

(i) *Internal Control Aspects:* The following may be incorporated in the audit programme to check the internal control aspects:

(a) Maintaining separate register for hired assets, leased asset and jointly owned assets.

(b) Maintaining register of fixed asset and reconciling to physical inspection of fixed asset and to nominal ledger.

(c) All movements of assets are accurately recorded.

(d) Authorisation be obtained for –

(i) a declaring a fixed asset scrapped.

(ii) selling a fixed asset.

(e) Check whether additions to fixed asset register are verified and checked by authorised person.

(f) Proper recording of all additions and disposal.

(g) Examining procedure for the purchase of new fixed assets, including written authority, work order, voucher and other relevant evidence.

(h) Regular review of adequate security arrangements.

(i) Periodic inspection of assets is done or not.

(j) Regular review of insurance cover requirements over fixed assets.

(ii) *Assets Register*: To review the registers and records of plant, machinery, etc. showing clearly the date of purchase of assets, cost price, location, depreciation charged, etc.

(iii) *Cost Report and Journal Register*: To review the cost relating to each plant and machinery and to verify items which have been capitalised.

(iv) *Code Register*: To see that each item of plant and machinery has been given a distinct code number to facilitate identification and verify the maintenance of Code Register.

(v) *Physical Verification*: To see physical verification has been conducted at frequent intervals.

(vi) *Movement Register*: To verify (a) whether a Movement Register for movable equipments and (b) log books in case of vehicles, etc. are being maintained properly.

(vii) *Assets Disposal Register*: To review whether assets have been disposed off after proper technical and financial advice and sales/disposal/retirement, etc. of these assets are governed by authorisation, sales memos or other appropriate documents.

(viii) *Spare Parts Register*: To examine the maintenance of a separate register of tools, spare parts for each plant and machinery.

(ix) *Review of Maintenance:* To scrutinise the programme for an actual periodical servicing and overhauling of machines and to examine the extent of utilisation of maintenance department services.

(x) *Review of Obsolescence:* To scrutinise whether expert's opinion have been obtained from time to time to ensure purchase of technically most useful efficient and advanced machinery after a thorough study.

(xi) *Review of R&D:* To review R&D activity and ascertain the extent of its relevance to the operations of the organisation, maintenance of machinery efficiency and prevention of early obsolescence.

3

Risk Assessment and Internal Control

Question 1

Briefly discuss the compliance procedures and their use in evaluation of internal controls.

Answer

Compliance Procedures and Evaluation of Internal Controls: The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information. According to it, compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. Obtaining audit evidence from compliance procedures is intended to reasonably assure the auditor in respect of the following assertions:

Existence - that the internal control exists.

Effectiveness - that the internal control is operating effectively.

Continuity - that the internal control has so operated throughout the period of intended reliance.

The auditor formulating his opinion on financial information needs reasonable assurance that transactions are properly authorised and recorded in the accounting records and that the transactions have not been omitted. Internal controls, even if fairly simple, may contribute to the reasonable assurance the auditor seeks. The auditors' objective in studying and evaluating internal controls is to establish the reliance he can place thereon in determining the nature, timing and extent of his substantive auditing procedures.

Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in place and are also effective. Compliance procedures enable the auditor to determine the existence, effectiveness and continuous operation of the internal control system. These procedures include tests requiring inspection of documents supporting transactions to gain evidence that controls have operated properly. For example, the auditor may see that the documents have been properly authorised. The auditor may also make enquiries about the observation of controls, for example, determining who actually performs each function not merely who is supposed to perform it. Compliance procedures are conducted by the auditor to gain evidence that those internal controls on which he intends to rely operates generally as identified by him and they function effectively throughout the period of intended reliance. The concept of effective operation recognises that some deviations from prescribed controls may have occurred.

Based on the results of his compliance procedures, the auditor evaluates whether the internal controls are adequate for his purpose. If based on the results of the compliance procedures, the auditor concludes that it is not appropriate to rely on a particular internal control to the degree previously contemplated, he should ascertain whether there is another control which would satisfy his purpose and on which he might rely (after applying appropriate compliance procedures). Alternatively, he may modify the nature, timing or the extent of his substantive audit procedures.

Question 2

(a) As auditor of Z 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 X Ltd., you would like to consider audit risk at the financial statement level. What are the factors can influence your decision?

Answer

(a) Basic Accounting Control Objectives: The 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) Audit risk at financial statement level: 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.

Question 3

The Auditor of S Limited has just commenced the statutory audit. What should be considerations for the effectiveness of a system of internal check?

Answer

Considerations for the effectiveness of a System of Internal Check: The term "internal check" is defined as the "checks on day to day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud". The following aspects should be considered in framing a system of internal check:

(i) No single person should have an independent control over any important aspect of the business. The work done by one person should automatically be checked by another person in routine course.

(ii) The duties/work of members of the staff should be changed from time to time without any previous notice so that the same officer or subordinate does not, without a break, perform the same function for a considerable length of time.

(iii) Every member of the staff should be encouraged to go on leave at least once in a year so that frauds successfully concealed by such a person can be detected in his absence.

(iv) Persons having physical custody of assets must not be permitted to have access to the books of accounts.

(v) There should be an accounting control in respect of each important class of assets, in addition, these should be periodically inspected so as to establish their physical condition.

(vi) The system of Budgetary Control should be introduced.

(vii) For stock-taking, at the close of the year, trading activities should, if possible, be suspended. The task of stock-taking, and evaluation should be done by staff belonging to other than stock section.

(viii) The financial and administrative powers should be sub divided very judicially and the effect of such division should be reviewed periodically.

(ix) Finally, the system must be capable of being expanded or contracted to correspond to the size of the concern.

Question 4

As the auditor of a large multi locational company, in the planning process, you are requested to identify the inherent audit risk at the account balance and class of transaction level.

Answer

Evaluating Risk at the account balance and class of transaction level: As per SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", risk of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures. Assertions at different levels are discussed below:

(a) Assertions about classes of transactions and events for the period under audit-

  (i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.

  (ii) Completeness—all transactions and events that should have been recorded have been recorded.

  (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.

  (iv) Cut-off—transactions and events have been recorded in the correct accounting period.

  (v) Classification—transactions and events have been recorded in the proper accounts.

(b) Assertions about account balances at the period end-

  (i) Existence—assets, liabilities, and equity interests exist.

  (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

  (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.

  (iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

When making assertions about the financial statements of certain entities, especially, for example, where the Government is a major stakeholder, in addition to those assertions mentioned before, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.

To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors, 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. Inherent audit risk at the level of Account Balance and Class of Transactions is:

(i) Quality of the accounting system.

(ii) Financial statements are likely to be susceptible to misstatement, for example, accounts which required adjustment in the prior period or which involve a high degree of estimation.

(iii) The complexity of underlying transactions and other events which might require using the work of an expert.

(iv) The degree of judgement involved in determining account balances.

(v) Susceptibility of assets to loss or misappropriation, for example, assets which are highly desirable and movable such as cash.

(vi) The completion of unusual and complex transactions, particularly at or near period end.

(vii) Transactions not subjected to ordinary processing.

Question 5

(a) *Corporate responsibility as envisaged under Sarbanes and Oxley Act-2002. Briefly explain.*

(b) Y Co. Ltd. has five entertainment centers to provide recreational facilities for public especially for children and youngsters at 5 different locations in the peripheral of 200 kilometers. Collections are made in cash. Specify the adequate system towards collection of money.

Answer

(a) Corporate Responsibility under Sarbanes Oxley Act of 2002 : The Sarbanes–Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002 is a United States federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom. The act contains eleven titles and establishes corporate accountability and civil and criminal penalties for white – collar crimes. The title three deals with the Corporate Responsibility which is as follows:

(i) The audit committee to be more independent through enhancement of their over sight responsibilities and one of the Audit committee members to be financial expert.

(ii) Requires CEO & CFO to issue certification of the quarterly financial results and annual reports to SEC as part of compliance with Form 10K.

(iii) Provides rules of conduct for companies managerial and their officers regarding Pension matters.

(iv) To Comply with SEC rules requiring attorneys to report violation of securities to the company's CEO or Chief Legal Counsel and to Audit Committee if no action is taken.

(b) Control System over Selling and Collection of Tickets: In order to achieve proper internal control over the sale of tickets and its collection by the Y Co. Ltd., following system should be adopted -

(i) **Printing of tickets:** Serially numbered pre-printed tickets should be used and designed in such a way that any type of ticket used cannot be duplicated by others in order to avoid forgery. Serial numbers should not be repeated during a reasonable period, say a month or year depending on the turnover. The separate series of the serial should be used for such denomination.

(ii) **Ticket sales:** The sale of tickets should take place from the Central ticket office at each of the 5 centres, preferably through machines. There should be proper control over the keys of the machines.

(iii) **Daily cash reconciliation:** Cash collection at each office and machine should be reconciled with the number of tickets sold. Serial number of tickets for each entertainment activity/denomination will facilitate the reconciliation.

(iv) **Daily banking:** Each day's collection should be deposited in the bank on next working day of the bank. Till that time, the cash should be in the custody of properly authorized person preferably in joint custody for which the daily cash in hand report should be signed by the authorized persons.

(v) **Entrance ticket:** Entrance tickets should be cancelled at the entrance gate when public enters the centre.

(vi) **Advance booking:** If advance booking of facility is made available, the system should ensure that all advance booked tickets are paid for.

(vii) **Discounts and free pass:** The discount policy of the Y Co. Ltd. should be such that the concessional rates, say, for group booking should be properly authorized and signed forms for such authorization should be preserved.

(viii) **Surprise checks:** Internal audit system should carry out periodic surprise checks for cash counts, daily banking, reconciliation and stock of unsold tickets etc.

Question 6

"Corporate accountability and civil and criminal penalties for white collar crimes." Comment on the major provisions of Sarbanes Oxley Act.

Answer

Major provisions of Sarbanes Oxley Act: The Sarbanes Oxley Act of 2002 established corporate accountability and civil and criminal penalties for white – collar crimes. This act also known as the Public Company Accounting Reform and Investor Protection Act of 2002 and commonly called SOX or Sarbox; is a United States federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom. These scandals resulted in a decline of public trust in accounting and reporting practices.

This Act provides regulatory bodies and courts to take various actions –civil and criminal proceedings in connection of misstatements amounting to accounting scandals and fraudulent financial reports, other frauds on securities matters, obstruction of justice and retaliating against corporate whistleblowers. The Act also enforce tougher civil and criminal penalties for fraud and accounting scandals, securities fraud and certain other forms of obstruction of justice. As per SOX protect employer against corporate whistle blowers (person who provide evidence of fraud in the company).

Some of the major provisions of Sarbanes-Oxley Act of 2002 are:

(i) Creation of the Public Company Accounting Oversight Board (PCAOB);

(ii) A requirement that public companies evaluate and disclose the effectiveness of their internal controls as they relate to financial reporting, and that independent auditors for such companies "attest" (i.e., agree, or qualify) to such disclosure;

(iii) Certification of financial reports by chief executive officers and chief financial officers;

(iv) Auditor independence, including outright bans on certain types of work for audit clients and pre-certification by the company's Audit Committee of all other non-audit work;

(v) Ban on most personal loans to any executive officer or director;

(vi) Accelerated reporting of insider trading;

(vii) Prohibition on insider trades during pension fund blackout periods;

(viii) Enhanced criminal and civil penalties for violations of securities law;

(ix) A requirement that companies listed on stock exchanges have fully independent audit committees that oversee the relationship between the company and its auditor;

(x) Additional disclosure;

(xi) Significantly longer maximum jail sentences and larger fines for corporate executives who knowingly and willfully misstate financial statements, although maximum sentences are largely irrelevant because judges generally follow the Federal Sentencing Guidelines in setting actual sentences;

(xii) Employee protections allowing those corporate fraud whistleblowers who file complaints with OSHA within 90 days to win reinstatement, back pay and benefits, compensatory damages, and congressional page abatement orders, and reasonable attorney fees and costs.

Question 7

As auditor of Z 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?

Answer

Basic Accounting Control Objectives: The 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.

Question 8

State briefly eight provisions of the Sarbanes-Oxley Act of 2002, which shall, if strictly applied to Indian Corporates, get fruitful results.

Answer

Following are some provisions of the Sarbanes-Oxley Act of 2002, which, if enacted in India may be further fruitfull is respect of Indian corporate:

(i) More independence be given to Audit Committee and auditor.

(ii) Ban on personal loan to Directors / Executive Officers of a Company.

(iii) Strict reporting by an auditor on insider trading.

(iv) Additional disclosures imposed on financial reporting.

(v) If there is any conflict between company and its auditor, the Audit Committee should be empowered to resolve the same.

(vi) Higher penalties and criminal prosecution on financial frauds.

(vii) To include effectiveness of Internal Control System in the financial reporting.

(viii) More responsibilities must be imposed on managerial personal with higher penalties and prosecutions on the breach.

(ix) Strict action against white collar crime.

(x) Disclosers of the % of shareholdings by Directors, Executive Officers and principal shareholders.

Question 9

Explain briefly the Flow Chart technique for evaluation of the Internal Control system.

Answer

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 flow-chart.

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. However, in drawing the flow chart, the auditor has to take few precautions, e.g., flow-charts should not be lengthy and cumbersome, should be neat, should portray the flow completely with final disposal of papers and there should be proper use of symbols and lines. The auditor will be able to visually correlate the functions and the related controls and assess the adequacy and effectiveness thereof much quickly than a possibly in any other method. 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.

Question 10

Highlight the provisions relating to corporate responsibility under Sarbanes Oxley Act of 2002.

Answer

Corporate Responsibility under Sarbanes Oxley Act of 2002: The Sarbanes–Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002 is a United States federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom. The act contains eleven titles and establishes corporate accountability and civil and criminal penalties for white – collar crimes. The title three deals with the Corporate Responsibility which is as follows:

(i) The audit committee to be more independent through enhancement of their over sight responsibilities and one of the Audit committee members to be financial expert.

(ii) Requires CEO& CFO to issue certification of the quarterly financial results and annual reports to SEC as past of compliance with Form 10K.

(iii) Provides rules of conduct for companies managerial and their officers regarding Pension matters.

(iv) To Comply with SEC rules requiring attorneys to report violation of securities to the company's CEO or chief legal counsel & to Audit Committee if no action is taken.

Question 11

Explain the concept of Audit risk at the level of financial statements.

Answer

Audit risk at the financial statement level: As per SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

Risks at the financial statement level may derive in particular from deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:

(i) Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.

(ii) Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion on the financial statements.

Question 12

Write short notes on Sampling Risk.

Answer

Sampling Risk: As per SA 530 "Audit Sampling", sampling risk is the risk that arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached 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 a test 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 a test of controls, that controls are less effective than they actually are, or in the case of a test 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.

Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

Question 13

Write short notes on Factors relevant in evaluation of Inherent Risk.

Answer

Relevant Factors in evaluation of inherent risk: While developing an overall audit plan, the auditor is required to assess inherent risk at financial statement level and is then required to relate his assessment to material account balances and the class of transactions. To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors, 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. Normally an auditor evaluates inherent risk by assessing factors such as integrity of the management, experience and knowledge of the management, turnover of key management personnel, circumstances which may motivate the management to misstate the financial statement when its financial performance is not satisfactory, nature of entity's business prone to rapid technological obsolescence dealing with large number of related parties, etc.

3

Risk Assessment and Internal Control

Question 1

The Auditor of S Limited has just commenced the statutory audit. What should be considerations for the effectiveness of a system of internal check? (4 Marks, November, 2013)

Answer

Considerations for the effectiveness of a System of Internal Check: The term "internal check" is defined as the "checks on day to day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud". The following aspects should be considered in framing a system of internal check:

(i) No single person should have an independent control over any important aspect of the business. The work done by one person should automatically be checked by another person in routine course.

(ii) The duties/work of members of the staff should be changed from time to time without any previous notice so that the same officer or subordinate does not, without a break, perform the same function for a considerable length of time.

(iii) Every member of the staff should be encouraged to go on leave at least once in a year so that frauds successfully concealed by such a person can be detected in his absence.

(iv) Persons having physical custody of assets must not be permitted to have access to the books of accounts.

(v) There should be an accounting control in respect of each important class of assets, in addition, these should be periodically inspected so as to establish their physical condition.

(vi) The system of Budgetary Control should be introduced.

(vii) For stock-taking, at the close of the year, trading activities should, if possible, be suspended. The task of stock-taking, and evaluation should be done by staff belonging to other than stock section.

(viii) The financial and administrative powers should be sub divided very judicially and the effect of such division should be reviewed periodically.

(ix) Finally, the system must be capable of being expanded or contracted to correspond to the size of the concern.

Question 2

As the auditor of a large multi locational company, in the planning process, you are requested to identify the inherent audit risk at the account balance and class of transaction level.

(4 Marks, May, 2013)

Or

Explain the concept of Audit risk at the level of account balance and class of transactions.

(4 Marks, May 2008)

Answer

Evaluating Risk at the account balance and class of transaction level: As per SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", risk of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures. Assertions at different levels are discussed below:

(a) Assertions about classes of transactions and events for the period under audit-

  (i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.

  (ii) Completeness—all transactions and events that should have been recorded have been recorded.

  (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.

  (iv) Cut-off—transactions and events have been recorded in the correct accounting period.

  (v) Classification—transactions and events have been recorded in the proper accounts.

(b) Assertions about account balances at the period end-

  (i) Existence—assets, liabilities, and equity interests exist.

  (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

  (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.

(iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

When making assertions about the financial statements of certain entities, especially, for example, where the Government is a major stakeholder, in addition to those assertions mentioned before, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.

Question 3

(a) Corporate responsibility as envisaged under Sarbanes and Oxley Act-2002. Briefly explain. (3 Marks, November, 2011)

(b) Y Co. Ltd. has five entertainment centers to provide recreational facilities for public especially for children and youngsters at 5 different locations in the peripheral of 200 kilometers. Collections are made in cash. Specify the adequate system towards collection of money. (6 Marks, November, 2011)

Answer

(a) Corporate Responsibility under Sarbanes Oxley Act of 2002 : The Sarbanes–Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002 is a United States federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom. The act contains eleven titles and establishes corporate accountability and civil and criminal penalties for white – collar crimes. The title three deals with the Corporate Responsibility which is as follows:

(i) The audit committee to be more independent through enhancement of their over sight responsibilities and one of the Audit committee members to be financial expert.

(ii) Requires CEO& CFO to issue certification of the quarterly financial results and annual reports to SEC as part of compliance with Form 10K.

(iii) Provides rules of conduct for companies managerial and their officers regarding Pension matters.

(iv) To Comply with SEC rules requiring attorneys to report violation of securities to the company's CEO or Chief Legal Counsel and to Audit Committee if no action is taken.

(b) Control System over Selling and Collection of Tickets: In order to achieve proper internal control over the sale of tickets and its collection by the Y Co. Ltd., following system should be adopted -

(i) **Printing of tickets:** Serially numbered pre-printed tickets should be used and designed in such a way that any type of ticket used cannot be duplicated by others in order to avoid forgery. Serial numbers should not be repeated during a reasonable period, say a month or year depending on the turnover. The separate series of the serial should be used for such denomination.

(ii) **Ticket sales:** The sale of tickets should take place from the Central ticket office at each of the 5 centres, preferably through machines. There should be proper control over the keys of the machines.

(iii) **Daily cash reconciliation:** Cash collection at each office and machine should be reconciled with the number of tickets sold. Serial number of tickets for each entertainment activity/denomination will facilitate the reconciliation.

(iv) **Daily banking:** Each day's collection should be deposited in the bank on next working day of the bank. Till that time, the cash should be in the custody of properly authorized person preferably in joint custody for which the daily cash in hand report should be signed by the authorized persons.

(v) **Entrance ticket:** Entrance tickets should be cancelled at the entrance gate when public enters the centre.

(vi) **Advance booking:** If advance booking of facility is made available, the system should ensure that all advance booked tickets are paid for.

(vii) **Discounts and free pass:** The discount policy of the Y Co. Ltd. should be such that the concessional rates, say, for group booking should be properly authorized and signed forms for such authorization should be preserved.

(viii) **Surprise checks:** Internal audit system should carry out periodic surprise checks for cash counts, daily banking, reconciliation and stock of unsold tickets etc.

Question 4

"Corporate accountability and civil and criminal penalties for white collar crimes." Comment on the major provisions of Sarbanes Oxley Act. (5 Marks, November, 2010)

Answer

Major provisions of Sarbanes Oxley Act: The Sarbanes Oxley Act of 2002 established corporate accountability and civil and criminal penalties for white – collar crimes. This act also known as the Public Company Accounting Reform and Investor Protection Act of 2002 and commonly called SOX or Sarbox; is a United States federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom. These scandals resulted in a decline of public trust in accounting and reporting practices.

This Act provides regulatory bodies and courts to take various actions –civil and criminal proceedings in connection of misstatements amounting to accounting scandals and fraudulent financial reports, other frauds on securities matters, obstruction of justice and retaliating against corporate whistleblowers. The Act also enforce tougher civil and criminal penalties for fraud and accounting scandals, securities fraud and certain other forms of obstruction of justice. As per SOX protect employer against corporate whistle blowers (person who provide evidence of fraud in the company).

Some of the major provisions of Sarbanes-Oxley Act of 2002 are:

(i) Creation of the Public Company Accounting Oversight Board (PCAOB);

(ii) A requirement that public companies evaluate and disclose the effectiveness of their internal controls as they relate to financial reporting, and that independent auditors for such companies "attest" (i.e., agree, or qualify) to such disclosure;

(iii) Certification of financial reports by chief executive officers and chief financial officers;

(iv) Auditor independence, including outright bans on certain types of work for audit clients and pre-certification by the company's Audit Committee of all other non-audit work;

(v) Ban on most personal loans to any executive officer or director;

(vi) Accelerated reporting of insider trading;

(vii) Prohibition on insider trades during pension fund blackout periods;

(viii) Enhanced criminal and civil penalties for violations of securities law;

(ix) A requirement that companies listed on stock exchanges have fully independent audit committees that oversee the relationship between the company and its auditor;

(x) Additional disclosure;

(xi) Significantly longer maximum jail sentences and larger fines for corporate executives who knowingly and willfully misstate financial statements, although maximum sentences are largely irrelevant because judges generally follow the Federal Sentencing Guidelines in setting actual sentences;

(xii) Employee protections allowing those corporate fraud whistleblowers who file complaints with OSHA within 90 days to win reinstatement, back pay and benefits, compensatory damages, and congressional page abatement orders, and reasonable attorney fees and costs.

Question 5

As auditor of Z 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? (4 Marks, May, 2010)

Answer

Basic Accounting Control Objectives: The 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.

Question 6

State briefly eight provisions of the Sarbanes-Oxley Act of 2002, which shall, if strictly applied to Indian Corporates, get fruitful results. (8 Marks, November, 2009)

Answer

Following are some provisions of the Sarbanes-Oxley Act of 2002, which, if enacted in India may be further fruitfull is respect of Indian corporate:

(i) More independence be given to Audit Committee and auditor.

(ii) Ban on personal loan to Directors / Executive Officers of a Company

(iii) Strict reporting by an auditor on insider trading.

(iv) Additional disclosures imposed on financial reporting.

(v) If there is any conflict between company and its auditor, the Audit Committee should be empowered to resolve the same.

(vi) Higher penalties and criminal prosecution on financial frauds.

(vii) To include effectiveness of Internal Control System in the financial reporting.

(viii) More responsibilities must be imposed on managerial personal with higher penalties and prosecutions on the breach.

(ix) Strict action against white collar crime.

(x) Disclosers of the % of shareholdings by Directors, Executive Officers and principal shareholders.

Question 7

Explain briefly the Flow Chart technique for evaluation of the Internal Control system.

(4 Marks, November, 2009)

Or

Write short explanatory notes on Flow chart technique for evaluation of internal control.

(4 Marks, May, 2004)

Answer

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 flow-chart.

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. However, in drawing the flow chart, the auditor has to take few precautions, e.g., flow-charts should not be lengthy and cumbersome, should be neat, should portray the flow completely with final disposal of papers and there should be proper use of symbols and lines. The auditor will be able to visually correlate the functions and the related controls and assess the adequacy and effectiveness thereof much quickly than a possibly in any other method. 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.

Question 8

Highlight the provisions relating to corporate responsibility under Sarbanes Oxley Act of 2002.

(4 Marks, November, 2008)

Answer

Corporate Responsibility under Sarbanes Oxley Act of 2002: The Sarbanes–Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002 is a United States federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom. The act contains eleven titles and establishes corporate accountability and civil and criminal penalties for white – collar crimes. The title three deals with the Corporate Responsibility which is as follows:

(i) The audit committee to be more independent through enhancement of their over sight responsibilities and one of the Audit committee members to be financial expert.

(ii) Requires CEO& CFO to issue certification of the quarterly financial results and annual reports to SEC as past of compliance with Form 10K.

(iii) Provides rules of conduct for companies managerial and their officers regarding Pension matters.

(iv) To Comply with SEC rules requiring attorneys to report violation of securities to the company's CEO or chief legal counsel & to Audit Committee if no action is taken.

Question 9

Explain the concept of Audit risk at the level of financial statements. *(4 Marks, May 2008)*

Answer

Audit risk at the financial statement level: As per SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

Risks at the financial statement level may derive in particular from deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:

(i) Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.

(ii) Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion on the financial statements.

Question 10

Write short notes on Sampling Risk. *(4 Marks, May, 2006)*

Answer

Sampling Risk: As per SA 530 "Audit Sampling", sampling risk is the risk that arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached 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 a test 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 a test of controls, that controls are less effective than they actually are, or in the case of a test 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.

Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

Question 11

Write short notes on Factors relevant in evaluation of Inherent Risk. *(4 Marks, May, 2005)*

Answer

Relevant Factors in evaluation of inherent risk: While developing an overall audit plan, the auditor is required to assess inherent risk at financial statement level and is then required to relate his assessment to material account balances and the class of transactions. To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors, 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. Normally an auditor evaluates inherent risk by assessing factors such as integrity of the management, experience and knowledge of the management, turnover of key management personnel, circumstances which may motivate the management to misstate the financial statement when its financial performance is not satisfactory, nature of entity's business prone to rapid technological obsolescence dealing with large number of related parties, etc.

4

Audit under Computerised Information System (CIS) Environment

Question 1

"Where the financial Accounting System has not been computerised, the auditor need not verify Computerised Management System ".

Answer

Any typical organisation structure would involve different kinds of systems having regard to its nature of operational activities. Apart from the accounting information flow, there may be various other operational departments such as production, purchase, sales, computer department, maintenance, research and development, corporate services, etc. It is quite likely that certain aspects of the organisation have been inter-connected through computers and a central computerised management system is functional in the organisation. On the other hand, merely because the financial accounting system has not been computerised would not mean that the information generated in other sections of the organisation has no effect on manually maintained accounting records. The auditor's field of interest covers most of the business's activities. For although primarily he will be concerned with the financial accounting department activities, accounting information will be generated by many departments. And it is the auditor's task to see that all this information is reliable. The system of internal control extends beyond those matters which relate directly to the functions of the accounting system. Thus, operational controls such as quality control, work standards, budgetary control, quantitative control, etc. also acquire significance. This is where administrative controls also become important. The auditor should familiarise himself with the tasks being undertaken, the systems that have been developed and the reports generated from such applications. This would provide information which could improve the quality of his own work and enable him to judge better the quality of the accounting systems and internal checks which come within his preview. It would also assist him in making a qualitative judgement as to the state of affairs of the company and give an opportunity to review his audit programme to reduce routine work and improve quality by assuring that more time is spent by his assistants in other areas to improve quality and offer constructive suggestions. It is very important that the auditor must evaluate such control system also, which have bearing on reliability of financial information.

Question 2

What is an Audit Trail? Briefly describe the special audit techniques using the computer as an audit tool.

Answer

Audit Trail: Changes in hardware and software of data processing system have significantly changed the approach to auditing. The work of an auditor would be hardly affected if "audit trail" is maintained i.e. if it were still possible to relate, on a 'one-to-one' basis, the original input with the final output. In a manual accounting system, it is possible to relate the recording of a transaction at each successive stage enabling an auditor to locate and identify all documents from beginning to end for the purposes of examining documents, totalling and cross-referencing.

In first and early second-generation computer systems, a complete audit trail was generally available. However, with the advent of modern machines, the CIS environment has become more complex. This led to use of exception reporting by the management which effectively eliminated the audit trail between input and output. The lack of visible evidence may occur at different stages in the accounting process, for example:

(i) Input documents may be non-existent where sales orders are entered online. In addition, accounting transactions, such as discounts and interest calculations, may be generated by computer programmes with no visible authorisation of individual transactions.

(ii) The system may not produce a visible audit trail of transactions processed through the computer. Delivery notes and suppliers' invoices may be matched by a computer programme. In addition, programmed control procedures, such as checking customer credit limits, may provide visible evidence only on an exception basis. In such cases, there may be no visible evidence that all transactions have been processed.

(iii) Output reports may not be produced by the system. In addition, a printed report may only contain summary totals while supporting details are retained in computer files.

Special Audit Techniques: In the absence of audit trail, the auditor needs the assurance that the programmes are functioning correctly in respect of specific items by using special audit techniques. The absence of input documents or the lack of visible audit trail may require the use of Computer Assisted Audit Techniques (CAATs) i.e. using the computer as an audit tool. The effectiveness and efficiency of auditing procedures may be enhanced through the use of CAATs. Popularly, two common types of CAATs are in vogue, viz., test packs or test data and audit software or computer audit programmes. Normally speaking, special audit techniques may be used under the following circumstances:

(i) to ensure the correct functioning of important programme controls;

(ii) to overcome losses of audit trail;

(iii) to reduce audit costs or increase the efficiency of the audit.

Audit Software: Audit software consists of computer programmes used by the auditor, as part of his auditing procedures, to process data of audit significance from the entity's accounting system. It may consist of package programmes, purpose-written programmes, and utility programmes and systems management programs. Regardless of the source of the programmes, the auditor should substantiate their validity for audit purposes prior to use.

- Package Programs are generalized computer programs designed to perform data processing functions, such as reading data, selecting and analyzing information, performing calculations, creating data files and reporting in a format specified by the auditor.
- Purpose-Written Programs perform audit tasks in specific circumstances. These programs may be developed by the auditor, the entity being audited or an outside programmer hired by the auditor. In some cases, the auditor may use an entity's existing programs in their original or modified state because it may be more efficient than developing independent programs.
- Utility Programs are used by an entity to perform common data processing functions, such as sorting, creating and printing files. These programs are generally not designed for audit purposes, and therefore may not contain features such as automatic record counts or control totals.
- System Management Programs are enhanced productivity tools that are typically part of a sophisticated operating systems environment, for example, data retrieval software or code comparison software. As with utility programs these tools are not specifically designed for auditing use and their use requires additional care.

Test Data: Test data techniques are used in conducting audit procedures by entering data (e.g., a sample of transactions) into an entity's computer system, and comparing the results obtained with predetermined results. This enables to ascertain whether the controls residing in the hardware and in the programmes are operating correctly. Test data is used to test specific controls in computer programmes, such as online password and data access controls. Examples of such uses are:

(i) Test transactions selected from previously processed transactions or created by the auditor to test specific processing characteristics of an entity's computer system. Such transactions are generally processed separately from the entity's normal processing.

(ii) Test transactions in an integrated test facility where a "dummy" unit (e.g., a department or employee) is established and to which test transactions are posted during the normal processing cycle.

When test data is processed with the entity's normal processing, the auditor should ensure that the test transactions are subsequently eliminated from the entity's accounting records.

Question 3

A limited company having turnover of approximately ₹ 50 crores uses a tailor made accounting software package. In the said package, all transactions are recorded, processed and the final accounts generated from the system. The management tells you that in view of the voluminous nature of day books, there is no need to print them and that audit can be conducted on the computer itself. The management further assures you that any 'query based reports' as required can be generated and printed. As a statutory auditor of the company, enumerate the procedures you would adopt to conduct the audit.

Answer

A key feature of the accounting software package used by the company definitely involves the absence of a clear audit trail. In other words, transactions cannot be easily traced or co-related from the individual supporting documents of those transactions. Moreover, the management does not wish to print the daybooks in view of the voluminous nature since it may involve extensive costs. This has naturally led to extensive dependence by management upon the "exception reporting" principle.

From the auditor's point of view, it must also be conceded, the exception reports in the form of 'query-based reports' which isolate the above data provide him with the very material that he requires for most of his verification work. The only problem which it raises, and it is a serious one, is that he cannot simply assume that the programmes which produce the exception reports are reliable in respect of the following factors:

(i) operating accurately;

(ii) printing out all the exceptions which exist; and

(iii) bound by programmed control parameters which meet the company's genuine internal control requirements.

In view of the above, whether management relies upon exception reports, it effectively eliminated the audit trail between input and output and the auditor is forced to test the invisible processes which purport to embody the controls, and produce the output such as it is. These tests, which invariably involve the use by the auditor of the computer itself, are known as tests through the machine. In the 'through the machine' approach, the auditor starts by proving the accuracy of the input data, and then thoroughly examines (by applying tests) the processing procedures with a view to establishing the following that:

(i) all input is actually entered into the computer.

(ii) neither the computer nor the operators can cause undetected irregularities in the final reports.

(iii) the programmes appear, on the evidence of rejection and exception routines, to be functioning correctly.

(iv) all operator intervention during processing is logged and scrutinised by the DP manager.

The auditor in such circumstances will have to first evaluate the existing controls. For the same, he has to do the following:

(i) Evaluate the internal control system especially the controls and checks existing for recording the transactions, i.e., he has to verify at what level transactions can be entered into the system and what checks are available to prevent any unauthorised data entry and for rectifying errors/omissions in the transactions entered.

(ii) Evaluate at what level there is authority given for modification of transactions already entered. Is there any authority given only to a senior employee to carry out modifications? Or is it that once transactions are entered and validated no further modifications are possible thereto.

(iii) Whether there is a provision in the software for carrying out an on line audit of transactions, i.e. whether there a separate module in the package, where a separate password given to the auditor and once he has seen and approved a particular transaction/set of transactions, the same would be locked and no modifications would be possible by anyone (including the senior most employee) in the company.

(iv) Whether there are proper procedures for backup of data on a regular basis and whether the said procedures are being strictly followed.

(v) In case of any loss of data whether there is a clear defined recovery procedure to minimize the loss of data due to power failures or any human errors.

(vi) The auditor may introduce some dummy data into the system and see the results obtained.

After the auditor has evaluated the above procedures, he has to prepare an audit plan depending on the results obtained from his earlier evaluation. Since the daybooks are not being printed, the plan can contain procedures wherein data is verified directly on the computer from the vouchers/invoices, etc. The audit plan will also require a lot of analytical procedures to be performed. Depending on the importance of various expense heads and other important account heads, the auditor will also obtain various reports from the system depending on various queries that he would have to identify. Some illustrative reports can be:

(i) To check whether proper classification is done for revenue/capital - a report can be obtained of all purchases (not being raw materials or other routine purchases) exceeding ₹ one lakh.

(ii) To check whether all freight outward bills are accounted for a report containing a month-wise co-relation between goods dispatched and freight amount paid. The same can be further co-related with the freight rates obtained from the bills.

Once the auditor has performed the above procedures, he would be able to form an opinion whether reliance can be placed on the accounting systems and the data recorded. If the auditor finds that reliance cannot be placed on the systems he can inform the management about the fact and also that the daybooks, etc., will need to printed to allow him to conduct the audit. The finalisation procedures to be followed even under this system would remain more or less similar to other accounting systems. The auditor can obtain reports of depreciation on fixed assets, inventory valuation and using the normal procedures find out whether reliance can be placed on them, e.g., if while valuing inventories the system is using the LIFO method, the same would not be acceptable and will need to be modified. Similarly depreciation calculations will have to be verified on a random basis to find out its reliability.

Question 4

"On-line real time processing system and batch processing system have their inherent strengths and weaknesses." Please comment.

Answer

On-line Real Time Processing System vs. Batch Processing System: In an on-line real-time (OLRT) processing system, transactions are entered as they occur, and are processed as they are entered. These systems form the heart of management information systems. Given the continuous updating of the database as transactions are entered, the status of such files as accounts receivable, accounts payable, and inventory may be determined at any time. In an on-line real-time processing system, individual transactions are entered at terminal devices, validated and used to update related computer files immediately. An example is the application of cash receipts directly to customers' accounts. The results of such processing are then available immediately for inquiries or reports.

In a system with on-line batch processing, individual transactions are entered at a terminal device, subjected to certain validation checks and added to a transaction file that contains other transactions entered during the period. Later, during a subsequent processing cycle, the transaction file may be validated further and then used to update the relevant master-file. For example, journal entries may be entered master-file being updated on a monthly basis. Inquiries of, or reports generated from, the master-file will not include transactions entered after the last master-file update. In a batch processing system which is not on-line, transactions are accumulated and processed in group sales orders for the day, invoices to be recorded, and daily cash receipts might each be viewed as a "batch" of transactions, to be processed as a group. Batch processing systems are distinguished by their relative simplicity and reliability. They do not process transactions as quickly as the more advanced systems, nor do they possess the potential for providing timely information concerning the files updated by transactions processing. Given these limitations, the use of networked PCs terminals has become widespread, even among small entities. Batch processing systems are rarely found in today's systems environment.

Although powerful in terms of information capability, OLRT systems are more complex than batch processing systems. Moreover, they ordinarily do not provide the extent of audit trail documentation produced by batch system and for this they are more difficult to audit in terms of obtaining satisfaction concerning the existence of necessary controls, and of designing substantive testing procedures.

Conversely, in a batch processing system, the transaction are accumulated and processed in batches or groups. Control totals, both monetary and documentary, are also available for review to ensure completeness and accuracy of data being processed. The system is simple and reliable. However, its deficiency lies in the MIS is not updated on a concurrent basis and, therefore, information is not available on a timely basis.

Accordingly, it is a question of cost-benefit analysis as to which system will be more preferable to an entity.

Question 5

Indicate the control procedures which the auditor should adopt in applying CAAT (Computer Assisted Audit Technique) in an audit under CIS environment.

Answer

Computer Assisted Auditing Techniques (CAATs) involve performing audit procedures while conducting audit through the computer. Audit software and Test Data are two common type of CAATs. Using CAATs involves taking various measures including monitoring so that the use of CAATs by the auditor provides reasonable assurance that the audit objectives and detailed

specifications of CAATs have been met. It is to be seen that CAATs are not manipulated by staff of the entity. The specific procedures necessary to control the use of a CAATs will depend on the particular application. In establishing control, the auditor considers the need to:

(i) approve specifications and conduct a review of the work to be performed by CAAT;

(ii) review the entity's general controls that may contribute to the integrity of CAAT, for example, controls over program changes and access to computer files. When such controls cannot be relied on to ensure the integrity of CAAT, the auditor may consider processing CAAT application at another suitable computer facility; and

(iii) ensure appropriate integration of the output by the auditor into the audit process.

Procedures carried out by the auditor to control CAATs applications may include:

(i) participating in the design and testing of CAAT;

(ii) checking, if applicable, the coding of the program to ensure that it conforms with the detailed program specifications;

(iii) asking the entity's staff to review the operating system instructions to ensure that the software will run in the entity's computer installation;

(iv) running the audit software on small test files before running it on the main data files;

(v) checking whether the correct files were used, for example, by checking external evidence, such as control totals maintained by the user, and that those files were complete;

(vi) obtaining evidence that the audit software functioned as planned, for example, by reviewing output and control information; and

(vii) establishing appropriate security measures to safeguard the integrity and confidentiality of the data.

When using a CAAT, the auditor may require the cooperation of the entity's staff who have extensive knowledge of the computer installation. In such circumstances, the auditor should have reasonable assurance that the entity's staff did not improperly influence the results of the CAAT.

Question 6

Discuss some problems that will be encountered in CIS Environment in implementation of internal control.

Answer

Internal control system include separation of duties, delegation of authority and responsibility, a system of authorisation, adequate documents and records, physical control over assets and records, management supervision, independent checks on performance and periodic reconciliation of assets with records. In CIS environment, all these components must exist but computers affects the implementation of these internal controls in many ways. Some of the effects are as under:

(i) Separation of Duties - In a manual system, different persons are responsible for carrying out function like initiating, recording of transaction, safeguarding of assets, does not always apply in a computer system. For example, in a computer system, a program may carryout reconciliation of vendor invoice against a receipt document and also prepares a cheque payable to trade payables. Such operation through a program will be considered as incompatible functions in a manual system.

In minicomputer and microcomputer environments, separation of incompatible function could be even more difficult. Some such forms, allows, users to change programs and data entry without providing a record of these changes. Thus, it becomes difficult to determine whether incompatible function have been performed by system users.

(ii) Delegation of Authority and Responsibility - A structured authority and responsibility is an essential control within manual and computer environment. In a computer system however, a clean line of authority and responsibility might be difficult to establish because some resources are shared among multiple users. For instance, one objective of using a data base management system is to provide multiple users with access to the same data, thereby reducing the control problems that arise with maintaining redundant data, when multiple users have access to the same data and the integrity of the data is somehow violated, it is not always easy to trace who is responsible for corrupting the data and who is responsible for identifying and correcting the error. Some organisation identified a single user as the owner of the data.

(iii) Competent and Trustworthy Personnel - Skilled, competent, well-trained and experienced in formation system personnel have been in short supply. Since substantial power is often vested in the person responsible for the computer information system development, implementation, operation and maintenance within the organisation, competent and trustworthy personnel is very much in demand. Unfortunately, the non availability of competent personnel, forced many organisation to compromise on their choice of staff. Moreover, it is not always easy for organisation to assess the competence and integrity of their system staff. High turnover among those staff has been the norm. Some information systems personnel lack a well developed sense of ethics and some enjoy in subverting controls.

(iv) System of Authorisation - Management authorisation of transaction may be either:

(1) general authorisation to establish policies for the organisation,

(2) specific authorisation applying to individual transactions. In manual system, auditors evaluate the adequacy of procedures for authorisation by examining the work of employees. In a computer system, authorisation procedures often are embedded within a computer program. In a computer system, it is also more difficult to assess whether the authority assigned to individual persons is constant with managements policies. Thus, in evaluating the adequacy of authorisation procedures, auditors have to examine not only the work of employees but also the veracity of the programme processing.

(v) **Adequate Documents and Records -** In a manual system, adequate documents and records are required to provide an audit trail of activities within the system. In computer system, document support might not be necessary to initiate, execute and records some transaction. The task of a visible audit trail is not a problem for auditors, provided the systems have been designed to maintain a record of all events and that they are easily accessible. In well-designed computer systems, audit trails are more extensive than those maintained in manual systems unfortunately not all computer systems are well designed. This creates a serious control problem.

(vi) **Physical Control over Assets and Records -** Physical access to assets and records is critical in both manual systems and computer system. In a computer system the information system assets and records may be concentrated at a single site. The concentration of information systems assets and record also increases the losses that can arise from computer abuse or disaster. If the organisation does not have another suitable backup, it might be unable to continue operations.

(vii) **Adequate Management Supervision -** In a computer system, supervision of employee might have to be carried out remotely. Supervisory controls must be built into the computer system to compensate for the controls that usually can be exercised through observation and in inquiring computer system also make the activities of employees less visible to management. Because many activities are electronically controlled managers must periodically access the audit trial of employee activities and examine it for unauthorised actions.

(viii) **Independent Checks on Performance -** Checks by an independent person help to detect any errors or irregularities. In a computer system, if a program code is authorised accurate, and complete the system will always follow the laid down procedures in absence of other type of failures like hardware or systems software failure. Thus, independent checks on the performance of programs often have little value. Instead, the control emphasis shifts to ensuring the veracity of programme code. Auditors, must now evaluate the controls established for program development, modification operation and maintenance.

(ix) **Comparing Recorded Accountability with Assets -** In a manual system, independent staff prepares the basic data used for comparison purposes. In a computer system software is used to prepare this data. If unauthorised modifications occur to the program or the data files that the program uses, an irregularity might not be discovered, because traditional separation of duties no longer applies to the data being prepared for comparison purposes.

Question 7

State the important characteristics of an effective computer audit programme system.

Answer

Characteristics of an effective computer audit program system: Normally, the computer audit program developed for general purposes shall have to customised according to needs of the organisation. However, an examination of following features is necessary to ensure that it is effective:

(i) **Simplicity**: The system should be simple to use and eliminate the need for remembering countless details normally required in writing or revising computer programs.

(ii) **Understandability**: The system should be readily understandable by members of the audit staff, even those with little computer expertise. The capabilities of the system should be known and it should be easy to use. Coding forms provided should not be difficult to understand.

(iii) **Adaptability**: The system should be capable of writing computer audit programs for the various types of computers used in the company or expected to be acquired. Thus the package will be usable if the equipment is changed in the future.

(iv) **Vendor technical support**: In considering the types of package to be acquired, it is important that the vendor provides adequate support. This includes assisting in the initial installation and providing adequate documentation. In addition, training provided for the audit staff is important. Also, maintenance service should be furnished, and provision made for future revisions in the programs.

(v) **Statistical sampling capability**: Since statistical sampling is an important application in auditing, the package should be able to perform the various statistical routines. This should include the selection of items on a random basis, determination of sample size, and evaluation of results at different confidence levels. In addition to simple random sampling and stratified sampling, it should have routines for more complex sampling such as cluster and multistage sampling.

(vi) **Acceptability**: The system should be acceptable to both the auditors and to computer centres. For the auditors the programs should be easily carried to the site and practical to use. For the computer centre the programs should be compatible with the system and be capable of minimum interference with normal routines.

(vii) **Processing Capabilities**: The package should be able to process many different types of applications. For example, it should accept all common file media and process multiple file input. It should have the capability for extended data selection and stratification. It should have the ability to operate under multiprogramming situations. It should have powerful, generalized audit commands.

(viii) **Report Writing**: The package should have a strong report writing function. This should include the ability to prepare multiple reports in a single program run and to generate flexible output report formats.

Question 8

What are the characteristics of 'On-line Computer System'?

Answer

Characteristics of 'On-line Computer System': The characteristics of on-line computer systems may apply to a number of the types of on-line systems discussed in the previous

section. The most significant characteristics relate to on-line data entry and validation, on-line access to the system by users, possible lack of visible transaction trail and potential programmer access to the system. The particular characteristics of a specific on-line system will depend on the design of that system.

(i) When data are entered on-line, they are usually subject to immediate validation checks. Data failing this validation would not be accepted and a message may be displayed on the terminal screen, providing the user with the ability to correct the data and re-enter the valid data immediately. For example, if the user enters an invalid inventory part number, an error message will be displayed enabling the user to re-enter a valid part number.

(ii) Users may have on-line access to the system that enables them to perform various functions, e.g., to enter transactions and to read, change or delete programs and data files through the terminal devices. Unlimited access to all of these functions in a particular application is undesirable because it provides the user with the potential ability to make unauthorised changes to the data and programs. The extent of this access will depend upon such things as the design of the particular application and the implementation of software designed to control access to the system.

(iii) An on-line computer system may be designed in a way that does not provide supporting documents for all transactions entered into the system. However, the system may provide details of the transactions on request or through the use of transaction logs or other means. Illustrations of these types of systems include orders received by a telephone operator who enters them on-line without written purchase orders, and cash withdrawals through the use of automated teller machines.

(iv) Programmers may have on-line access to the system that enables them to develop new programs and modify existing programs. Unrestricted access provides the programmer with the potential to make unauthorised changes to programs and obtain unauthorised access to other parts of the system. The extent of this access depends on the requirements of the system. For example, in some systems, programmers may have access only to programs maintained in a separate program development and maintenance library; whereas, in emergency situations which require changes to programs that are maintained on-line, programmers may be authorised to change the operational programs. In such cases, formal control procedures would be followed subsequent to the emergency situation to ensure appropriate authorisation and documentation of the changes.

Question 9

In determining whether to use Computer Assisted Auditing Techniques (CAATs), what are the factors that a statutory auditor has to consider?

Answer

Consideration of Factors in Use of CAATs: 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 CAAT. 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 a data**: It includes selection of samples, applying analytical procedures, time involved in application of CAAT, 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.

Question 10

"The method of collecting Audit evidence and evaluating the same changes drastically under CIS Environment". Comment on the above.

Answer

Auditor must provide a competent, independent opinion as to whether the financial statements records and report a true and fair view of the state of affairs of an entity. However, computer systems have affected how auditors need to collect and evaluate evidence. These aspects are discussed below:

(i) Changes to Evidence Collection - Collecting evidence on the reliability of a computer system is often more complex than collecting evidence on the reliability of a manual system. Auditors have to face a diverse and complex range of internal control technology that did not exist in manual system, like:

(1) accurate and complete operations of a disk drive may require a set of hardware controls not required in manual system,

(2) system development control include procedures for testing programs that again are not necessary in manual control.

Since, Hardware and Software develop quite rapidly, understanding the control technology is not easy. With increasing use of data communication for data transfer, research is focused a cryptographic controls to project the privacy of data. Unless auditor's keep up with these developments, it will become difficult to evaluate the reliability of communication network competently.

The continuing and rapid development of control technology also makes it more difficult for auditors to collect evidence on the reliability of controls. Even collection of audit evidence through manual means is not possible. Hence, auditors have to run through computer system themselves if they are to collect the necessary evidence. Though generalized audit softwares are available the development of these tools cannot be relied upon due to lack of information. Often auditors are forced to compromise in some way when performing the evidence collection

(ii) Changes to Evidence Evaluation - With increasing complexity of computer systems and control technology, it is becoming more and more difficult for the auditors to evaluate the consequences of strength and weaknesses of control mechanism for placing overall reliability on the system.

Auditors need to understand:

(a) whether a control is functioning reliably or multi functioning,

(b) traceability of control strength and weakness through the system. In a shared data environment a single input transaction may update multiple data item used by diverse, physically disparate user, which may be difficult to understand.

Consequences of errors in a computer system are a serious matter as errors in computer system tend to be deterministic, i.e., an erroneous program will always execute data incorrectly. Moreover, the errors are generated at high speed and the cost and effort to correct and rerun program may be high. Errors in computer program can involve extensive redesign and reprogramming. Thus, internal controls that ensure high quality computer systems should be designed implemented and operated upon. The auditors must ensure that these control are sufficient to maintain assets safeguarding, data integrity, system effectiveness and system efficiency and that they are in position and functioning.

Question 11

The auditor must evaluate major clauses of control used in a Computerised Information system to enhance its reliability – Comment.

Answer

The reliability of a component is a function of control that acts on the component. In a computer system the following are the major types of controls are used to enhance component reliability which the auditor must evaluate:

(i) **Authenticity Control:** They are exercised to verify the identity of the individuals or process involved in a system. (Pass word, digital signature etc.)

(ii) **Accuracy Control:** These attempts to ensure the correctness of the data and processes in a system (Programme validation check).

(iii) **Completeness Control:** This ensures that no data is missing and all processing is carried through to its proper conclusion.

(iv) **Privacy Control:** This ensures the protection of data from inadvertent or unauthorised disclosure.

(v) **Audit Trail Controls:** This ensures the traceability of all events occurred in a system.

(vi) **Redundancy Control:** It ensures that processing of data is done only once.

(vii) **Existence Control:** It attempts to ensure the on going availability of all system resources.

(viii) **Asset safeguarding controls:** It attempts to ensure that all resources within a system are protected from destruction or corruption.

(ix) **Effectiveness Control:** It attempts to ensure that the system achieves its goals.

(x) **Efficiency Control:** It attempts to ensure that a system uses minimum resources to achieve its goals.

Question 12

The role of an auditor in collecting audit evidences under EDP system is more complex than under the manual system - Discuss.

Answer

Changes to Evidence Collection - Collecting evidence on the reliability of a computer system is often more complex than collecting evidence on the reliability of a manual system. Auditors have to face a diverse and complex range of internal control technology that did not exist in manual system, like:

a) accurate and complete operations of a disk drive may require a set of hardware controls not required in manual system,

b) system development control include procedures for testing programs that again are not necessary in manual control.

Since, Hardware and Software develop quite rapidly, understanding the control technology is not easy. With increasing use of data communication for data transfer, research is focussed an cryptographic controls to project the privacy of data. Unless auditor's keep up with these developments, it will become difficult to evaluate the reliability of communication network competently.

The continuing and rapid development of control technology also makes it more difficult for auditors to collect evidence on the reliability of controls. Even collection of audit evidence through manual means is not possible. Hence, auditors have to run through computer system themselves if they are to collect the necessary evidence. Though generalized audit softwares are available the development of these tools cannot be relied upon due to lack of information. Often auditors are forced to compromise in some way when performing the evidence collection.

Question 13

Different types of controls which operate over date moving into, through and out of the computer. Auditor is required to review such control. Comment.

Answer

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 form the date entered. The review process can be laid down as follows:

(i) **Organisation structure and control**: The entity may have different functions under the CIS environment. There will be Date 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.

(ii) **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.

(iii) **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.

(iv) **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.

(v) **Processing controls**: These controls are must for integrity of data. Processing validation checks should be applied.

(vi) **Recording Controls**: This is for enabling the records to be kept free of errors.

(vii) **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.

(viii) **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.

Question 14

Z Ltd. has its entire operations including accounting computerized. As the audit partner you are concerned about inherent and control risk for material financial statement assertions. What could be the areas you look forward for deficiencies and risk identification?

Answer

Risk Assessment - The auditor in accordance with SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", should make an assessment of inherent and control risk for material financial statement assertions.

In a CIS environment the risk of a Material financial statement ascertain being erroneously stated could arise from the deficiencies in the following case as-

(i) Program Development and maintenance.

(ii) System software support.

(iii) Operations including processing of data.

(iv) Physical CIS security.

(v) Control over access to specialized utility program.

These deficiencies would tend to have a negative impact on all application systems that are processed through the computer.

Question 15

In the audit of K Ltd, its auditor wants to use CAATs for performing various audit procedures. Guide him as to what procedures can be performed using CAATs.

Answer

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

(i) 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;

(ii) Analytical procedures, for example, identifying inconsistencies or significant fluctuations;

(iii) 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 ;

(iv) Sampling programs to extract data for audit testing;

(v) Tests of application controls, for example, testing the functioning of a programmed control; and

(vi) Re-performing calculations performed by the entity's accounting systems.

Question 16

You are a member of an audit team of B & C Associates, auditors of a Multinational Company YB Co. Ltd. The company is working in CIS environment. The partner in charge of B & C Associates asked you to draw out the audit plan for evaluating the reliability of controls.

Answer

Audit Plan for Evaluating the Reliability of Controls in CIS Environment: In evaluating the effects of a control, the auditor needs to assess the reliability by considering the various attributes of a control. Some of the attributes for example are that the control is in place and is functioning as desired, generality versus specificity of the control with respect to the various types of errors and irregularities that might occur, general control inhibit the effect of a wide variety of errors and irregularities as they are more robust to change controls in the application sub-system which tend to be specific control because component in these sub-system execute activities having less variety, that whether the control acts to prevent, detect or correct errors etc.

The auditor focuses here on-

(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:

(i) Ensure that authorized, correct and complete data is made available for processing;

(ii) Provide for timely detection and correction of errors.

(iii) Ensure that the case of interruption in the work of the CIS environment due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records;

(iv) Ensure that accuracy and completeness of output;

(v) Provide adequate data security against fire and other calamities, wrong processing, frauds etc.,

(vi) Prevent unauthorized amendments to the program;

(vii) Provide for safe custody of source code of application software and data files.

Question 17

What are the considerations which an auditor should consider while evaluating the reliability of the accounting and internal control systems in a CIS environment?

Answer

While evaluating the reliability of the accounting and internal control systems, the auditor would consider whether these systems:

(i) Ensure that authorized, correct and complete data is made available for processing;

(ii) Provide for timely detection and correction of errors;

(iii) Have Data recovery arrangement and Back-up system in place at all times;

(iv) 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;

(v) Ensure the accuracy and completeness of output;

(vi) Provide adequate data security against fire and other calamities, wrong processing, frauds etc.;

(vii) Prevent unauthorized amendments to the program;

(viii) Provide for safe custody of source code of application software and data files.

Question 18

E & Co, a firm of Chartered Accountants, requires your help in identifying the audit procedures that can be performed using CAATs. Please guide them.

Answer

CAATs may be used by E & Co, a firm of Chartered Accountants, in performing various auditing procedures, including the following:

(i) 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;

(ii) analytical procedures, for example, identifying inconsistencies or significant fluctuations;

(iii) 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;

(iv) sampling programs to extract data for audit testing;

(v) tests of application controls, for example, testing the functioning of a programmed control; and

(vi) Reperforming calculations performed by the entity's accounting systems.

4

Audit under Computerised Information System (CIS) Environment

Question 1

Q Ltd. operates in an ERP environment. Its auditor requires your assistance on the aspects that are needed to be looked into in respect of control over input and output of transactions. Kindly help him. (4 Marks, November, 2013)

Answer

Control Over Input transactions: Control are designed to provide reasonable assurance that-

(i) transactions are properly authorised before being processed by the computer.

(ii) transactions are accurately converted into machine readable from and recorded in the computer data files.

(iii) transaction are not lost, added, duplicated or improperly changed.

(iv) incorrect transactions are rejected, corrected and if necessary, resubmitted on a timely basis.

Control Over Output transactions: Designed to provide reasonable assurance that-

(i) results of processing are accurate.

(ii) access to output is restricted to authorised personnel.

(iii) output is provided to appropriate authorised personnel on a timely basis.

Question 2

E & Co, a firm of Chartered Accountants, requires your help in identifying the audit procedures that can be performed using CAATs. Please guide them. (4 Marks, May, 2013)

Or

In the audit of K Ltd, its auditor wants to use CAATs for performing various audit procedures. Guide him as to what procedures can be performed using CAATs. (6 Marks, May, 2012)

Answer

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

(i) 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;

(ii) analytical procedures, for example, identifying inconsistencies or significant fluctuations;

(iii) 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;

(iv) sampling programs to extract data for audit testing;

(v) tests of application controls, for example, testing the functioning of a programmed control; and

(vi) Reperforming calculations performed by the entity's accounting systems.

Question 3

What are the considerations which an auditor should consider while evaluating the reliability of the accounting and internal control systems in a CIS environment? (8 Marks, November, 2012)

Answer

While evaluating the reliability of the accounting and internal control systems, the auditor would consider whether these systems:

(i) Ensure that authorized, correct and complete data is made available for processing;

(ii) Provide for timely detection and correction of errors;

(iii) Have Data recovery arrangement and Back-up system in place at all times;

(iv) 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;

(v) Ensure the accuracy and completeness of output;

(vi) Provide adequate data security against fire and other calamities, wrong processing, frauds etc.;

(vii) Prevent unauthorized amendments to the program;

(viii) Provide for safe custody of source code of application software and data files.

Question 4

You are a member of an audit team of B & C Associates, auditors of a Multinational Company YB Co. Ltd. The company is working in CIS environment. The partner in charge of B & C Associates asked you to draw out the audit plan for evaluating the reliability of controls.

(5 Marks, November, 2011)

Answer

Audit Plan for Evaluating the Reliability of Controls in CIS Environment: In evaluating the effects of a control, the auditor needs to assess the reliability by considering the various attributes of a control. Some of the attributes are- whether 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:

(i) Ensure that authorized, correct and complete data is made available for processing;

(ii) Provide for timely detection and correction of errors;

(iii) Ensure that the case of interruption in the work of the CIS environment due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records;

(iv) Ensure that accuracy and completeness of output;

(v) Provide adequate data security against fire and other calamities, wrong processing, frauds etc.;

(vi) Prevent unauthorized amendments to the program;

(vii) Provide for safe custody of source code of application software and data files.

Question 5

Z Ltd. has its entire operations including accounting computerized. As the audit partner you are concerned about inherent and control risk for material financial statement assertions. What could be the areas you look forward for deficiencies and risk identification?

(4 Marks, May, 2011)

Answer

Risk Assessment: The auditor in accordance with SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment" should make an assessment of inherent and control risk for material financial statement assertions.

In a CIS environment the risk of a Material financial statement ascertain being erroneously stated could arise from the deficiencies in the following case as-

(i) Program Development and maintenance.

(ii) System software support.

(iii) Operations including processing of data.

(iv) Physical CIS security.

(v) Control over access to specialized utility program.

These deficiencies would tend to have a negative impact on all application systems that are processed through the computer.

Question 6

Different types of controls which operate over date moving into, through and out of the computer. Auditor is required to review such control. Comment. (8 Marks, November, 2010)

Answer

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 date entered. The review process can be laid down as follows-

(i) **Organisation structure and control**: The entity may have different functions under the CIS environment. There will be Date 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.

(ii) **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.

(iii) **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.

(iv) **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.

(v) **Processing controls**: These controls are must for integrity of data. Processing validation checks should be applied.

(vi) **Recording Controls**: This is for enabling the records to be kept free of errors.

(vii) **Storage Controls**: The data is the heart of the CIS system. Backup and recovery facilities will ensure the proper data availability to the management.

(viii) **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.

Question 7

The role of an auditor in collecting audit evidences under EDP system is more complex than under the manual system - Discuss. *(8 Marks, November, 2009)*

Answer

Changes to Evidence Collection: Collecting evidence on the reliability of a computer system is often more complex than collecting evidence on the reliability of a manual system. Auditors have to face a diverse and complex range of internal control technology that did not exist in manual system, like-

(i) accurate and complete operations of a disk drive may require a set of hardware controls not required in manual system,

(ii) system development control include procedures for testing programs that again are not necessary in manual control.

Since, Hardware and Software develop quite rapidly, understanding the control technology is not easy. With increasing use of data communication for data transfer, research is focused on cryptographic controls to project the privacy of data. Unless auditor's keep up with these developments, it will become difficult to evaluate the reliability of communication network competently.

The continuing and rapid development of control technology also makes it more difficult for auditors to collect evidence on the reliability of controls. Even collection of audit evidence through manual means is not possible. Hence, auditors have to run through computer system themselves if they are to collect the necessary evidence. Though generalized audit softwares are available the development of these tools cannot be relied upon due to lack of information. Often auditors are forced to compromise in some way when performing the evidence collection.

Question 8

The auditor must evaluate major clauses of control used in a Computerised Information system to enhance its reliability – Comment. *(8 Marks, November, 2008)*

Answer

Internal Controls in a CIS Environment: The reliability of a component is a function of control that acts on the component. In a computer system following are the major types of controls that are used to enhance component reliability which the auditor must evaluate:

(i) **Authenticity Control:** They are exercised to verify the identity of the individuals or process involved in a system (Password, digital signature etc.).

(ii) **Accuracy Control:** These attempts to ensure the correctness of the data and processes in a system (Programme validation check).

(iii) **Completeness Control:** This ensures that no data is missing and all processing is carried through to its proper conclusion.

(iv) **Privacy Control:** This ensures the protection of data from inadvertent or unauthorised disclosure.

(v) **Audit Trail Controls:** This ensures the traceability of all events occurred in a system.

(vi) **Redundancy Control:** It ensures that processing of data is done only once.

(vii) **Existence Control:** It attempts to ensure the ongoing availability of all system resources.

(viii) **Asset safeguarding controls:** It attempts to ensure that all resources within a system are protected from destruction or corruption.

(ix) **Effectiveness Control:** It attempts to ensure that the system achieves its goals.

(x) **Efficiency Control:** It attempts to ensure that a system uses minimum resources to achieve its goals.

Question 9

Answer the following:

(a) "Use of Audit Software would increase the probability of detecting frauds". Comment. *(6 Marks, May, 2008)*

(b) What is an Audit Trail? *(4 Marks, May, 2008)*

Answer

(a) Use of Audit Software: CAATs allow the auditor to give access to data without dependence on the client, test the reliability of client software and perform audit tests more efficiently. CAATs are used to perform various audit procedures like-

(i) Tests of details of transactions and balances e.g. use of audits software to test all or a few transactions in a computer file.

(ii) Analytical review procedures e.g. use of audit software to identify unusual fluctuations or items.

(iii) Compliance tests of IT application controls e.g. use of test data to test the functioning of a programmed procedure.

However, the methods of applying audit procedures to gather evidence may be influenced by the methods of computer processing. Sometimes, in some accounting systems that use of computer for processing significant applications, it may difficult or impossible for an auditor to obtain certain data for inspection, inquiry or confirmation without computer assistance.

CAAT in fraud Detection: In an EDP environment, the Auditor is required to plan his work by exercising reasonable care and skill in such a manner that there is reasonable expectation of detecting material misstatements in the financial information resulting from fraud or error.

Use of the CAAT/ audit software systems will help the auditor to identify errors and frauds in the accounting and internal control system.

Conclusion: Frauds are intentional. Auditing through the computer with adequate knowledge of computer systems may highlight some frauds, but there is no empirical evidence to prove the assertion that the use of audit software systems has unearthed well concealed frauds.

Thus, it cannot be conclusively said that use of audit software systems increases the probability of detection of fraud.

(b) Audit Trail: Audit Trail can be defined as those documents, records, journals, ledgers, master files etc. that enables an auditor to trace the transactions from the source document to the summarised total in accounting reports or vice-versa.

Audit trail is the visible means whereby the auditor may have a business transactions through all the stages in which it features in the records of the business. For example, sequentially numbered sales invoice copies would normally be listed in a register or day book and subsequently filed either in numerical or chronological sequence. It would then be possible to trace a particular invoice from the day book to the original file or vice-versa by reference to the number or date of the invoice.

In a manual accounting system, it is possible to relate the recoding of a transaction at each successive stage enabling an auditor to locate and identify all documents from beginning to end for the purposes of examining documents, totalling and cross-totalling referencing.

However, in an EDP environment, the use of exception reporting by management has effectively eliminated the audit trail between input and output. Frequently computer generated totals, analysis and balances are not printed out in detail because the management is not exercising control through verification of the individual items processed.

Question 10

"The method of collecting Audit evidence and evaluating the same changes drastically under EDP Auditing". Comment on the above. *(8 Marks, November, 2007)*

Answer

Effects of EDP Auditing: Auditor must provide a competent, independent opinion as to whether the financial statements records and report a true and fair view of the state of affairs of an entity. However, computer systems have affected how auditors need to collect and evaluate evidence. These aspects are discussed below-

(i) **Changes to Evidence Collection -** Collecting evidence on the reliability of a computer system is often more complex than collecting evidence on the reliability of a manual system. Auditors have to face a diverse and complex range of internal control technology that did not exist in manual system, like:

(a) accurate and complete operations of a disk drive may require a set of hardware controls not required in manual system,

(b) system development control include procedures for testing programs that again are not necessary in manual control.

Since, Hardware and Software develop quite rapidly, understanding the control technology is not easy. With increasing use of data communication for data transfer, research is focussed an cryptographic controls to project the privacy of data. Unless auditor's keep up with these developments, it will become difficult to evaluate the reliability of communication network competently.

The continuing and rapid development of control technology also makes it more difficult for auditors to collect evidence on the reliability of controls. Even collection of audit evidence through manual means is not possible. Hence, auditors have to run through computer system themselves if they are to collect the necessary evidence. Though generalized audit softwares are available the development of these tools cannot be relied upon due to lack of information. Often auditors are forced to compromise in some way when performing the evidence collection.

(ii) **Changes to Evidence Evaluation -** With increasing complexity of computer systems and control technology, it is becoming more and more difficult for the auditors to evaluate the consequences of strength and weaknesses of control mechanism for placing overall reliability on the system.

Auditors need to understand:

(a) whether a control is functioning reliably or multi functioning,

(b) traceability of control strength and weakness through the system. In a shared data environment a single input transaction may update multiple data item used by diverse, physically disparate user, which may be difficult to understand.

Consequence of errors in a computer system is a serious matter as errors in computer system tend to be deterministic, i.e., an erroneous program will always execute data

incorrectly. Moreover, the errors are generated at high speed and the cost and effort to correct and rerun program may be high. Errors in computer program can involve extensive redesign and reprogramming. Thus, internal controls that ensure high quality computer systems should be designed implemented and operated upon. The auditors must ensure that these control are sufficient to maintain assets safeguarding, data integrity, system effectiveness and system efficiency and that they are in position and functioning.

Question 11

Write short notes on Factors to consider in determining the use of Computer Assisted Audit Techniques (CAATs). *(4 Marks, May, 2007)*

Or

In determining whether to use Computer Assisted Auditing Techniques (CAATs), what are the factors that a statutory auditor has to consider? *(6 Marks, May, 2005)*

Answer

Consideration of Factors in determining the use of CAATs:

(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 CAAT. 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 a data**: It includes selection of samples, applying analytical procedures, time involved in application of CAAT, 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.

Question 12

State the important characteristics of an effective system of Computer Audit Programme.

(8 Marks, November, 2006)

Or

State the important characteristics of an effective computer audit program system.

(8 Marks, May, 2004)

Answer

Important characteristics of an effective system of computer audit program: Normally, the computer audit program developed for general purposes shall have to customised according to needs of the organisation. However, an examination of following features is necessary to ensure that it is effective-

(i) **Simplicity**: The system should be simple to use and eliminate the need for remembering countless details normally required in writing or revising computer programs.

(ii) **Understandability**: The system should be readily understandable by members of the audit staff, even those with little computer expertise. The capabilities of the system should be known and it should be easy to use. Coding forms provided should not be difficult to understand.

(iii) **Adaptability**: The system should be capable of writing computer audit programs for the various types of computers used in the company or expected to be acquired. Thus the package will be usable if the equipment is changed in the future.

(iv) **Vendor technical support**: In considering the types of package to be acquired, it is important that the vendor provides adequate support. This includes assisting in the initial installation and providing adequate documentation. In addition, training provided for the audit staff is important. Also, maintenance service should be furnished, and provision made for future revisions in the programs.

(v) **Statistical sampling capability**: Since statistical sampling is an important application in auditing, the package should be able to perform the various statistical routines. This should include the selection of items on a random basis, determination of sample size, and evaluation of results at different confidence levels. In addition to simple random sampling and stratified sampling, it should have routines for more complex sampling such as cluster and multistage sampling.

(vi) **Acceptability**: The system should be acceptable to both the auditors and to computer centres. For the auditors the programs should be easily carried to the site and practical to use. For the computer centre the programs should be compatible with the system and be capable of minimum interference with normal routines.

(vii) **Processing Capabilities**: The package should be able to process many different types of applications. For example, it should accept all common file media and process multiple file input. It should have the capability for extended data selection and stratification. It should have the ability to operate under multiprogramming situations. It should have powerful, generalized audit commands.

(viii) **Report Writing**: The package should have a strong report writing function. This should include the ability to prepare multiple reports in a single program run and to generate flexible output report formats.

Question 13

Write short notes on Test Packs. *(4 Marks, May, 2006)*

Answer

Test Packs: Test pack is a technique to determine the correctness of the computer programming used to record transactions through the computer. Preparation of test pack requires a great deal of expertise. It may be prepared by the auditor himself with the help of the entity's staff or by the Internal Control department of the entity. Normally test packs are used where-

(i) a significant part of the control system is embodied in the programme;

(ii) there are gaps in audit trail making it difficult to trace output from input and to verify intermediate calculation; and

(iii) the volume of records is large, so that it may be more economical and more effective to use test packs rather than to trace the transactions manually.

The operations of a test pack involve following steps:

(i) The auditor or the Internal Audit Department prepares a set of special data covering different types of transactions containing valid and unvalid conditions.

(ii) Data will include both that falling outside the control parameters (and printed out as an error or conception) and that falling within the parameters (and hence should be processed normally).

(iii) The test data are seen on the clients' computer with the client's programme but under audit supervision.

(iv) The results of the test data are also prepared separately, independent of the computer/programme, and are compared with the results obtained by running the programme through the computer.

(v) If the results are identical, reliability of the computer programme is proved.

Question 14

Enumerate the risks and internal control characteristics in an audit conducted in Computer Information Systems (CIS) environment. *(8 Marks, November, 2005)*

Answer

The risks and internal control characteristics in CIS environment include the following:

(i) **Lack of transaction trails:** Some computer information systems are designed so that a complete transaction trail that is useful for audit purposes might exist for only a short period of time or only in computer readable form. Where a complex application system performs a large number of processing steps, there may not be a complete trail. Accordingly, errors embedded in an application's program logic may be difficult to detect on a timely basis by manual (user) procedures.

(ii) **Uniform processing of transactions:** Computer processing uniformly processes like transactions with the same processing instructions. Thus, the clerical errors ordinarily associated with manual processing are virtually eliminated. Conversely, programming errors (or other systemic errors in hardware or software) will ordinarily result in all transactions being processed incorrectly.

(iii) **Lack of segregation of functions:** Many control procedures that would ordinarily be performed by separate individuals in manual systems may become concentrated in a CIS environment. Thus, an individual who has access to computer programs, processing or data may be in a position to perform incompatible functions.

(iv) **Potential for errors and irregularities:** The potential for human error in the development, maintenance and execution of computer information systems may be greater than in manual systems, partially because of the level of detail inherent in these activities. Also, the potential for individuals to gain unauthorised access to data or to alter data without visible evidence may be greater in CIS than in manual systems.

In addition, decreased human involvement in handling transactions processed by computer information systems can reduce the potential for observing errors and irregularities. Errors or irregularities occurring during the design or modification of application programs or systems software can remain undetected for long periods of time.

(v) **Initiation or execution of transactions:** Computer information systems may include the capability to initiate or cause the execution of certain types of transactions, automatically. The authorisation of these transactions or procedures may not be documented in the same way as that in a manual system, and management's authorisation of these transactions may be implicit in its acceptance of the design of the computer information systems and subsequent modification.

(vi) **Dependence of other controls over computer processing:** Computer processing may produce reports and other output that are used in performing manual control procedures. The effectiveness of these manual control procedures can be dependent on the effectiveness of controls over the completeness and accuracy of computer processing. In turn, the effectiveness and consistent operation of transaction processing controls in computer applications is often dependent on the effectiveness of general computer information systems controls.

(vii) **Potential for increased management supervision:** Computer information systems can offer management a variety of analytical tools that may be used to review and supervise the operations of the entity. The availability of these analytical tools, if used, may serve to enhance the entire internal control structure.

(viii) **Potential for the use of computer-assisted audit techniques:** The case of processing and analysing large quantities of data using computers may require the auditor to apply general or specialised computer audit techniques and tools in the execution of audit tests.

Question 15

Write short notes on Walk Through Tests. *(4 Marks, May, 2005)*

Answer

Walk Through Tests: A walk-through is a procedure in which an auditor traces a transaction from its initiation through the company's information systems to the point when it is reflected in the financial reports. The auditor should perform one walk-through, at a minimum, for each major class of transactions. A walk-through provides evidence to confirm that the auditor understands (1) the process flow of transactions, (2) the design of identified controls for internal control components, including those related to preventing and detecting fraud, and (3) whether all points in the process have been identified at which misstatements related to relevant financial statement assertion could occur. Walk-throughs also provide evidence to evaluate the effectiveness of the controls' design and confirm that the controls have been placed in operation.

When performing a walk-through, the auditor should:

(i) Be sure that the walk-through encompasses the complete process (initiation, authorisation, recording, processing, and reporting) for each significant process identified, including controls intended to address fraud risk.

(ii) Ask the entity's personnel, at each of key stage in the process, about their understanding of what the company's prescribed procedures require.

(iii) Determine whether processing procedures are performed as expected on a timely basis, and look for any exceptions to prescribed procedures and controls.

(iv) Evaluate the quality of evidence provided and perform procedures that produce a level of evidence consistent with the auditor's objectives. The auditor should follow the whole process, using the same documents and technology that company staff use, asking questions of different personnel at each significant stage, and asking follow-up questions to identify any abuse of controls or fraud indicators.

Once a walk-through is performed, the auditor may carry forward the documentation, noting updates, unless significant changes make preparation of new documentation more efficient. If such significant changes occur in the process flow of transactions or supporting computer applications, the auditor should evaluate the nature of the changes and the effect on related accounts. The auditor should determine whether it is necessary to walk through transactions that were processed both before and after the change.

Question 16

(a) State the specific problems, which may arise in the implementation of internal control in an EDP system. (8 Marks, November, 2004)

(b) What are the characteristics of 'On-line Computer System'? (4 Marks, November, 2004)

(c) Explain: Tagging and Tracing (4 Marks, November, 2004)

Answer

(a) Specific problems of EDP relating to Internal Control: In an EDP system, the following specific problems arise in the implementation of internal control-

(i) **Separation of Duties -** In a manual system, different persons are responsible for carrying out function like initiating, recording of transaction, safeguarding of assets, does not always apply in a computer system. For example, in a computer system, a program may carryout reconciliation of vendor invoice against a receipt document and also prepares a cheque payable to creditors. Such operation through a program will be considered as incompatible functions in a manual system.

In minicomputer and microcomputer environments, separation of incompatible function could be even more difficult. Some such forms, allows, users to change programs and data entry without providing a record of these changes. Thus, it becomes difficult to determine whether incompatible function have been performed by system users.

(ii) **Delegation of Authority and Responsibility -** A structured authority and responsibility is an essential control within manual and computer environment. In a computer system however, a clean line of authority and responsibility might be difficult to establish because some resources are shared among multiple users. For instance, one objective of using a data base management system is to provide multiple users with access to the same data, thereby reducing the control problems that arise with maintaining redundant data, when multiple users have access to the same data and the integrity of the data is somehow violated, it is not always easy to trace who is responsible for corrupting the data and who is responsible for identifying and correcting the error. Some organisation identified a single user as the owner of the data.

(iii) **Competent and Trustworthy Personnel** - Skilled, competent, well-trained and experienced information system personnel have been in short supply. Since substantial power is often vested in the person responsible for the computer information system development, implementation, operation and maintenance within the organisation, competent and trustworthy personnel is very much in demand. Unfortunately, the non availability of competent personnel, forced many organisation to compromise on their choice of staff. Moreover, it is not always easy for organisation to assess the competence and integrity of their system staff. High turnover among those staff has been the norm. Some information systems personnel lack a well developed sense of ethics and some enjoy in subverting controls.

(iv) **System of Authorisation -** Management authorisation of transaction may be either:

(1) general authorisation to establish policies for the organisation,

(2) specific authorisation applying to individual transactions. In manual system, auditors evaluate the adequacy of procedures for authorisation by examining the work of employees. In a computer system, authorisation procedures often are embedded within a computer program. In a computer system, it is also more difficult to assess whether the authority assigned to individual persons is constant with managements policies. Thus, in evaluating the adequacy of authorisation procedures, auditors have to examine not only the work of employees but also the veracity of the programme processing.

(v) **Adequate Documents and Records -** In a manual system, adequate documents and records are required to provide an audit trail of activities within the system. In computer system, document support might not be necessary to initiate, execute and records

some transaction. The task of a visible audit trail is not a problem for auditors, provided the systems have been designed to maintain a record of all events and that they are easily accessible. In well-designed computer systems, audit trails are more extensive than those maintained in manual systems unfortunately not all computer systems are well designed. This creates a serious control problem.

(vi) **Physical Control over Assets and Records -** Physical access to assets and records is critical in both manual systems and computer system. In a computer system the information system assets and records may be concentrated at a single site. The concentration of information systems assets and record also increases the losses that can arise from computer abuse or disaster. If the organisation does not have another suitable backup, it might be unable to continue operations.

(vii) **Adequate Management Supervision -** In a computer system, supervision of employee might have to be carried out remotely. Supervisory controls must be built into the computer system to compensate for the controls that usually can be exercised through observation and in inquiring computer system also make the activities of employees less visible to management. Because many activities are electronically controlled managers must periodically access the audit trial of employee activities and examine it for unauthorised actions.

(viii) **Independent Checks on Performance -** Checks by an independent person help to detect any errors or irregularities. In a computer system, if a program code is authorised accurate, and complete the system will always follow the laid down procedures in absence of other type of failures like hardware or systems software failure. Thus, independent checks on the performance of programs often have little value. Instead, the control emphasis shifts to ensuring the veracity of programme code. Auditors must now evaluate the controls established for program development, modification operation and maintenance.

(ix) **Comparing Recorded Accountability with Assets -** In a manual system, independent staff prepares the basic data used for comparison purposes. In a computer system software is used to prepare this data. If unauthorised modifications occur to the program or the data files that the program uses, an irregularity might not be discovered, because traditional separation of duties no longer applies to the data being prepared for comparison purposes.

(b) Characteristics of 'On-line Computer System': The characteristics of on-line computer systems may apply to a number of the types of on-line systems discussed in the previous section. The most significant characteristics relate to on-line data entry and validation, on-line access to the system by users, possible lack of visible transaction trail and potential programmer access to the system. The particular characteristics of a specific on-line system will depend on the design of that system.

(i) **Validation Checks:** When data are entered on-line, they are usually subject to immediate validation checks. Data failing this validation would not be accepted and a message may be displayed on the terminal screen, providing the user with the ability to correct the data and re-enter the valid data immediately. For example, if the user enters an invalid inventory part number, an error message will be displayed enabling the user to re-enter a valid part number.

(ii) **On-Line Access:** Users may have on-line access to the system that enables them to perform various functions, e.g., to enter transactions and to read, change or delete programs and data files through the terminal devices. Unlimited access to all of these functions in a particular application is undesirable because it provides the user with the potential ability to make unauthorised changes to the data and programs. The extent of this access will depend upon such things as the design of the particular application and the implementation of software designed to control access to the system.

(iii) **Transaction Trail:** An on-line computer system may be designed in a way that does not provide supporting documents for all transactions entered into the system. However, the system may provide details of the transactions on request or through the use of transaction logs or other means. Illustrations of these types of systems include orders received by a telephone operator who enters them on-line without written purchase orders, and cash withdrawals through the use of automated teller machines.

(iv) **Programmer Access:** Programmers may have on-line access to the system that enables them to develop new programs and modify existing programs. Unrestricted acess provides the programmer with the potential to make unauthorised changes to programs and obtain unauthorised access to other parts of the system. The extent of this access depends on the requirements of the system. For example, in some systems, programmers may have access only to programs maintained in a separate program development and maintenance library; whereas, in emergency situations which require changes to programs that are maintained on-line, programmers may be authorised to change the operational programs. In such cases, formal control procedurs would be followed subsequent to the emergency situation to ensure appropriate authorisation and documentation of the changes.

(c) Tagging and Tracing: It is a technique better than Integrated Test Data Facility. It involves tagging the client's input data in such a way that relevant information is displayed at key points. It uses the actual data, and so the question of elimination of 'special entries' test data designed under Integrated Test Data Facility does not arise. The hard copy, so produced is available only to the auditor and may describe such inputs as hours worked in a pay period in excess of 50; or sales orders processed in excess of ₹ 1,00,000. This enables the auditor to examine transactions at the intermediate steps in processing. The advantage of the tagging and tracing approach lies in the use of actual data and elimination of the need for reversing journal entries. The disadvantage is that the erroneous data will not necessary be tagged. An effective combination approach may be to use the ITF approach (integrated test facility) for a few hypothetical transactions and the tagging and tracing approach to follow line data through a complex system.

5

Special Audit Techniques

Question 1

"An auditor while analysing the errors in a sample need not consider the qualitative aspects of errors detected." Please comment.

Answer

Characteristics of Sampling Errors: SA 530, "Audit Sampling", requires that while evaluating sample results, the auditor should analyse any errors detected in the samples having regard to appropriateness of the audit objective. An auditor while evaluating the errors detected in a sample selected by him from the total audit population, should analyse the nature of the errors, the projected errors in the total population and the sampling risk attached to it. While designing an audit sample, the auditor would also need to define the conditions that constitute the error keeping in view the audit objectives.

Flowing from the above, the auditor, therefore, would also need to consider the qualitative aspects of the errors detected by him. This will include the nature and reasons for the error and its possible effect on other phases. In case a repetitive pattern emerges from such analysis, for example, type of transaction, location, product line or period of time, the auditor would need to identify all items in the population, which contain such errors, resulting in a total population. The auditor would then need to carry out a separate analysis based on the examination carried out by him for each such sub-population. Accordingly, the auditor cannot be satisfied by detecting errors only but also would need to consider the qualitative aspects of such errors.

Question 2

The auditor should take into account the aggregate of all uncorrected misstatements including those involving estimates in his assessment of materiality in audit.

Answer

SA 320 "Materiality in Planning and Performing an Audit" requires that in forming his opinion on the financial information, the auditor should consider all material aspects, either individual or in aggregate which are relatively important for true and fair view of financial statements. In this context, the auditor should consider whether the effect of aggregate uncorrected misstatements on the financial information is material. Qualitative considerations also influence an auditor in reaching a conclusion as to whether the misstatements are material.

As per SA 320, the aggregate of uncorrected misstatements comprises: (a) specific misstatements identified by the auditor including the net effect of uncorrected misstatements identified during the audit of previous periods; and (b) the auditor's best estimate of other misstatements which cannot be specifically identified (that is, projected errors). The analytical procedures employed by the auditor may give him some indication about the existence of misstatements, which can be further substantiated by him through estimates process.

When an auditor uses audit sampling to test an account balance or class of transactions, he projects the amount of known misstatements identified by him in his sample to the items in the balance or class from which his sample was selected. That projected misstatement, along with the results of other substantive tests, contributes to the auditor's assessment of aggregate misstatement in the balance or class.

Impact of Misstatements: If the aggregate of the uncorrected misstatements that the auditor has identified approaches the materiality level, or if auditor determines that the aggregate of uncorrected misstatements causes the financial information to be materially misstated, he should consider requesting the management to adjust the financial information or extending his audit procedures. In any event, the management may want to adjust the financial information for known misstatements. The adjustment of financial information may involve, for example, application of appropriate accounting principles, other adjustments in amounts, or the addition of appropriate disclosure of inadequately disclosed matters. 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.

Question 3

"Obtaining audit evidence in performing compliance and substantive procedures." Comment.

Answer

Obtaining Audit Evidence: In performing compliance and substantive procedures, the auditor may obtain audit evidence by following methods:

(i) **Inspection:** Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

(ii) **Observation:** Observation consists of looking at a process **or** procedure being performed by the others. For example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

(iii) **External Confirmation:** An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition.

(iv) **Recalculation:** Recalculation consists of checking the arithmetical accuracy of documents or records. Recalculation may be performed manually or electronically.

(v) **Reperformance**: It involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

(vi) **Analytical Procedure**: Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

(vii) **Inquiry:** Inquiry consists of seeking information of knowledgeable persons, both financial and non- financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Question 4

What is Haphazard Sampling?

Answer

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.

Question 5

Write a short note on - Audit Risk.

Answer

Audit Risks: As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

For purposes of the SAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Three components of audit risk are:

- Inherent risk (risk that material errors will occur);
- Control risk (risk that the client's system of internal control will not prevent or correct such errors); and
- Detection risk (risk that any remaining material errors will not be detected by the auditor).

The nature of each of these types of risk and their interrelationship is discussed below:

Inherent risk - Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures.

Control risk - Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not

eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The SAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed.

Detection risk - For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as:

- adequate planning;
- proper assignment of personnel to the engagement team;
- the application of professional skepticism; and
- supervision and review of the audit work performed,

assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

Question 6

"Surprise Checks" help the auditors to ascertain whether the internal control system is operating effectively in a Company or not. Discuss.

Answer

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 inquires 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.

Question 7

Write short notes on the following:

(a) Factors relevant in evaluation of Inherent Risk

(b) Inquiry.

Answer

(a) Relevant Factors in evaluation of inherent risk: While developing an overall audit plan, the auditor is required to assess inherent risk at financial statement level and is then required to relate his assessment to material account balances and the class of transactions. To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors, 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. Normally an auditor evaluates inherent risk by assessing factors such as integrity of the management, experience and knowledge of the management, turnover of key management personnel, circumstances which may motivate the management to misstate the financial statement when its financial performance is not satisfactory, nature of entity's business prone to rapid technological obsolescence, dealing with large number of related parties etc.

(b) Inquiry: "SA 500 Audit Evidence" mentions inquiry as one of the methods of collecting evidence by seeking appropriate information from knowledgeable persons, both financial

and non- financial, within the entity or outside the entity. Inquiries may range from formal written inquires addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the auditor with information, which he did not possess earlier or may not provide him with corroborative evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

The need for inquiry may arise at every stage of auditing. Evaluating responses to inquiries is an integral part of the inquiry process.

Auditor has to make a statement in his report whether he has obtained all information and explanation that he considered necessary for audit. This is possible through inquiry, as one of the methods of obtaining information.

Question 8

In the audit of Hotel Great Stay Ltd., its auditor wants to use the analytical procedure as substantive procedure in respect of room rental income as well as payroll costs. Guide him as to how it can be done.

Answer

As per SA 520 on "Analytical Procedures", in some cases, even an unsophisticated predictive model may be effective as an analytical procedure.

In case of Payroll cost- Where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll.

In case of Room Rental Income of Hotel- Different types of analytical procedures provide different levels of assurance. Analytical procedures involving the prediction of total rental income in case of Hotel taking the room tariff rates, the number of rooms and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified.

Question 9

M Ltd. intends to intensify its advertisement strategy of hoarding advertisements to increase its sale during the impending festival season. You have been appointed as the special auditor to examine the expenditure under this head. What will be usual evidence you will look for in this case to justify the expenditure?

Answer

Hoarding Advertisement Expenses: The following would be the usual evidence to justify the expenditure-

(i) Copy of Resolution passed by the Company authorizing expenditure.

(ii) Examination of Quotations received from various advertising agencies.

(iii) Permission letter from the Municipal authorities.

(iv) Copies of contracts with advertising agencies.

(v) Bill/Invoice from advertising agency to ensure that rates charged for different types of advertisement are as per contract.

(vi) Receipts issued by the advertising agencies.

Question 10

Write short notes on Statistical and Non-Statistical Sampling.

Answer

Statistical and Non-statistical Sampling: Audit sampling means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

As per SA 530, "Audit Sampling", the auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

There are two major methods in which the size of the sample and the selection of individual items of the sample are determined. These methods are statistical and non-statistical sampling.

(i) Statistical sampling: This is a method of audit testing which is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

(ii) Non-statistical sampling: Under this method, the sample size and its composition are determined on the basis of the personal experience and knowledge of the auditor. This method has been in common application for many years because of its simplicity in operation. Traditionally, the auditor on the basis of his personal experience will determine the size of the sample and express it in terms that number of pages or personal accounts in the purchases or sales ledger to be checked. For example, March, June & September may be selected in year one and different months would be selected in the next year. An attempt would be made to avoid establishing a pattern of selection year after year to maintain an element of surprise as to what the auditor is going to check. It is a common practice to check large number of items towards the close of the year so that the adequacy of cut-off procedures can also be determined.

5

Special Audit Techniques

Question 1

In the audit of Hotel Great Stay Ltd. its auditor wants to use the analytical procedure as substantive procedure in respect of room rental income as well as payroll costs. Guide him as to how it can be done. (4 Marks, November, 2013)

Answer

As per **SA 520 on "Analytical Procedures"**, in some cases, even an unsophisticated predictive model may be effective as an analytical procedure.

In case of Payroll cost- Where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll.

In case of Room Rental Income of Hotel- Different types of analytical procedures provide different levels of assurance. Analytical procedures involving the prediction of total rental income in case of Hotel taking the room tariff rates, the number of rooms and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified.

Question 2

M Ltd. intends to intensify its advertisement strategy of hoarding advertisements to increase its sale during the impending festival season. You have been appointed as the special auditor to examine the expenditure under this head. What will be usual evidence you will look for in this case to justify the expenditure? (4 Marks, November, 2013)

Answer

Hoarding Advertisement Expenses: The following would be the usual evidence to justify the expenditure-

(i) Copy of Resolution passed by the Company authorizing expenditure.

(ii) Examination of Quotations received from various advertising agencies.

(iii) Permission letter from the Municipal authorities.

(iv) Copies of contracts with advertising agencies.

(v) Bill/Invoice from advertising agency to ensure that rates charged for different types of advertisement are as per contract.

(vi) Receipts issued by the advertising agencies.

Question 3

Write short notes on Statistical and Non-Statistical Sampling. (4 Marks, May, 2012)

Answer

Statistical and Non-statistical Sampling: Audit sampling means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

As per SA 530, "Audit Sampling", the auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

There are two major methods in which the size of the sample and the selection of individual items of the sample are determined. These methods are statistical and non-statistical sampling.

(i) *Statistical sampling:* This is a method of audit testing which is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

(ii) *Non-statistical sampling:* Under this method, the sample size and its composition are determined on the basis of the personal experience and knowledge of the auditor. This method has been in common application for many years because of its simplicity in operation. Traditionally, the auditor on the basis of his personal experience will determine the size of the sample and express it in terms that number of pages or personal accounts in the purchases or sales ledger to be checked. For example, March, June & September may be selected in year one and different months would be selected in the next year. An attempt would be made to avoid establishing a pattern of selection year after year to maintain an element of surprise as to what the auditor is going to check. It is a common practice to check large number of items towards the close of the year so that the adequacy of cut-off procedures can also be determined.

Question 4

In the audit planning process of X Ltd., you would like to consider audit risk at the financial statement level. What are the factors can influence your decision? (3 Marks, May, 2010)

Answer

Audit risk at financial statement level: As per SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

Risks at the financial statement level may derive in particular from deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:

(i) Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.

(ii) Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion on the financial statements.

Question 5

What are the considerations to be kept in mind while performing analytical procedures on data prepared by the client. *(6 Marks, June, 2009)*

Answer

As per SA 520 "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.

Question 6

What is Haphazard Sampling? *(6 Marks, May, 2008)*

Answer

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.

6

The Company Audit

Question 1

X Limited, a newly incorporated company in India commenced its business from April 1, 2013. The Company purchased fixed assets costing ₹ 4,000 lakhs on 01-04-2013 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal installments. Exchange rates were 1 Dollar = ₹ 40.00 and ₹ 42.50 as on 01-04-2013 and 31-03-2014 respectively. The company worked out foreign exchange loss as per AS 11 at ₹ 250 Lakhs and expensed the entire amount in the Statement of Profit and Loss. The Managing Director of the company was worried about this heavy revenue loss and asked the accountant not to follow AS 11 issued by the ICAI for this particular transaction. The Accountant of the company, followed the instruction of the Managing Director and removed exchange loss from the Statement of Profit and Loss but then he added the entire exchange loss to the value of fixed asset and computed the depreciation thereon. As an Auditor of X Limited how you would deal with this particular transaction?

Answer

Treatment of Changes in Foreign Exchange Rates: As per Para 46A(1) of AS 11 "The Effects of Changes in Foreign Exchange Rates'' inserted by Ministry of Corporate Affairs by way of notification, the exchange differences arising on reporting of long- term foreign currency monetary items in so far as they relate to the acquisition of a depreciable capital asset, in respect of accounting periods commencing on or after the 1st April, 2011, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, it can be accumulated in a ''Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long term asset or liability, by recognition as income or expense in each of such periods.

Thus, X Ltd. has the choice to avail this option. However, the company should disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized.

Question 2

Excellent Limited, a Company incorporated in India and listed with SEBI, has a scheme for payment of settlement allowance to retiring employees. Under the scheme, retiring employees are entitled to reimbursement of certain travel expenses for class they are entitled to as per company rules and regulations. Employees are also entitled to claim a lump-sum payment to cover expenses on food and stay during the travel. The Company also gives option to employees that they can claim a lump-sum amount equal to three months pay last drawn.

Excellent Limited have following accounting policies to record these travel expenses:

(i) Settlement allowance does not depend upon the length of service of employee. It is restricted to employee's eligibility under the travel rule of the company therefore all travel expenses fall under the category of defined contribution plans.

(ii) Since it is not related to the length of service of the employees, it is difficult to estimate reliably and there is no present obligation to pay employees as per AS 29 "Provisions, Contingent Liabilities and Contingent Assets", hence it is accounted for on claim basis.

You are statutory auditor of Excellent Limited. What would be your guidance to audit team?

Answer

Treatment of Employee Benefits Expenses: The present case falls under the category of defined benefit scheme under AS 15 "Employee Benefits". The said scheme encompasses cases where payment promised to be made to an employee at or near retirement presents significant difficulties in the determination of periodic charge to the statement of profit and loss. The contention of the Company that the settlement allowance will be accounted for on claim basis is not correct even if company's obligation under the scheme is uncertain and requires estimation. In estimating the obligation, assumptions may need to be made regarding future conditions and events, which are largely outside the company's control. Thus,

(i) Settlement allowance payable by the company is a defined retirement benefit, covered by AS 15.

(ii) A provision should be made every year in the accounts for the accruing liability on account of settlement allowance. The amount of provision should be calculated according to actuarial valuation.

(iii) Where, however, the amount of provision so determined is not material, the company can follow some other method of accounting for settlement allowances.

Question 3

X Ltd is engaged in the business of newspaper and radio broadcasting. It operates through different brand names. During FY 13-14 it incurred substantial amounts on external trade, business communication and branding expenses by participation in various corporate social responsibility initiatives. The company expects to benefits by this expenditure by attracting new customers over a period of time and accordingly it has capitalized the same under brand development expenses and intends to amortize the same over the period in which it expects the benefits to flow. As the statutory auditor of the company do you concur? Give reasons.

Answer

As per **AS-26 on "Intangible Assets"**, expenditure on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria.

In the given case, it incurred substantial amounts on external trade, business communication and branding expenses by participation in various corporate social responsibility initiatives. The company expects to benefits by this expenditure by attracting new customers over a period of time and accordingly it has capitalized the same under brand development expenses. Here, no intangible assets or other asset is acquired or created that can be recognized.

Therefore the accounting treatment by the company to amortize the entire expenditure over the period in which it expects the benefits to flow is not correct and the same should be debited to the Statement of Profit and Loss in the year of incurring.

Question 4

(a) *The Balance Sheet of G Ltd as at 31st March 14 is as under. Comment on the presentation in terms of Schedule III and Accounting Standards.*

Heading	***Note No.***	***31st March, 14***	***31st March, 13***
Equity & Liabilities			
	1	*XXX*	*XXX*
	2	*0*	*0*
	3	*XXX*	*XXX*
	4	*XXX*	*XXX*
Non-Current Liabilities		*XXX*	*XXX*
Deferred tax liability (Arising from Indian Income Tax)	*5*	*XXX*	*XXX*
Current Liabilities			
Trade Payables	*6*	*XXX*	*XXX*
Total		*XXXX*	*XXXX*
Assets			
Non-Current Assets			
Fixed Assets-Tangible	*7*	*XXX*	*XXX*
CWIP (including capital advances)	*8*	*XXX*	*XXX*
Current Assets			
Trade Receivables	*9*	*XXX*	*XXX*
Deferred Tax Asset (Arising from Indian Income Tax)	*10*	*XXX*	*XXX*
Debit balance of Statement of Profit and Loss		*XXX*	*XXX*
Total		*XXXX*	*XXXX*

(b) Z Ltd changed its employee remuneration policy from 1st of April 2013 to S provide for 12% contribution to provident fund on leave encashment also. As per the leave encashment policy the employees can either utilize or encash it. As at 31st March 14 the company obtained an actuarial valuation for leave encashment liability. However it did not provide for 12% PF contribution on it. The auditor of the company wants it to be provided but the management replied that as and when the employees availed leave encashment, the provident fund contribution was made. The company further contends that this is the correct treatment as it is not sure whether the employees will avail leave encashment or utilize it. Comment.

(c) T. Ltd. commenced its manufacturing activities from 1st April, 2013. In the course of production the company generated certain by-products. As at 31st March 14 the company did not value the by-products considering the value as insignificant. The auditor of the company is of the opinion that the by-products are inventory of the company and it should be valued and brought into books of account. Comment.

(d) K Ltd. had 5 subsidiaries as at 31st March 2014 and the investments in-subsidiaries are considered as long term and valued at cost. Two of the subsidiaries net worth eroded as at 31st March 14 and the prospects of their recovery are very bleak and the other three subsidiaries are doing exceptionally well. The company did not provide for the decline in the value of investments in two subsidiaries because the overall investment portfolio in subsidiaries did not suffer any decline' as the other three subsidiaries are doing exceptionally well. Comment.

Answer

(a) Following Errors are noticed in presentation as per Schedule III:

(i) Share Capital & Reserve & Surplus are to be reflected under the heading "Shareholders' funds", which is not shown while preparing the balance sheet. Although it is a part of Equity and Liabilities yet it must be shown under head "shareholders' funds". The heading "Shareholders' funds" is missing in the balance sheet given in the question.

(ii) Reserve & Surplus is showing zero balance, which is not correct in the given case. Debit balance of statement of Profit & Loss should be shown as a negative figure under the head 'Surplus'. The balance of 'Reserves and Surplus', after adjusting negative balance of surplus shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

(iii) Schedule III requires that Employee Stock Option outstanding should be disclosed under the heading "Reserves and Surplus"

(iv) Share application money refundable shall be shown under the sub-heading "Other Current Liabilities". As this is refundable and not pending for allotment, hence it is not a part of equity.

(v) Deferred Tax Liability has been correctly shown under Non-Current Liabilities. But Deferred tax assets and deferred tax liabilities, both, cannot be shown in

balance sheet because only the net balance of Deferred Tax Liability or Asset is to be shown.

(vi) Under the main heading of Non-Current Assets, Fixed Assets are further classified as under:

(a) Tangible assets

(b) Intangible assets

(c) Capital work in Progress

(d) Intangible assets under development.

Keeping in view the above, the CWIP shall be shown under Fixed Assets as Capital Work in Progress. The amount of Capital advances included in CWIP shall be disclosed under the sub-heading "Long term loans and advances" under the heading Non-Current Assets.

(e) Deferred Tax Asset shall be shown under Non-Current Asset. It should be the net balance of Deferred Tax Asset after adjusting the balance of deferred tax liability.

b) As per Para 11 of **AS-15 on "Employee Benefits"**, issued by the Institute of Chartered Accountants of India, an enterprise should recognize the expected cost of short-term employee benefits in the form of compensated absences in the case of accumulating compensated absences, when the employees render service that increases their entitlement to future compensated absences.

Since the company obtained actuarial valuation for leave encashment, it is obvious that the compensated absences are accumulating in nature. An enterprise should measure the expected cost of accumulating compensated absences as the additional amount that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date.

Here, Z Ltd will accumulate the amount of leave encashment benefits as it is the liability of the company to provide 12% PF on amount of leave encashment. Hence the contention of the auditor is correct that full provision should be provided by the company.

c) As per **AS-2 on "Valuation of Inventories"**, issued by the Institute of Chartered Accountants of India, a production process may result in more than one product being produced simultaneously. This is the case when joint products are produced or when there is a main product & by-products. If the costs of conversion of each product are not separable, they are allocated on a rational & consistent basis.

Most of the by-products as well as scrap or waste materials, by their nature, are immaterial. They are often measured at net realizable value & this value is deducted from the cost of the main product. In the given case, as the value of the by-products is insignificant, the realizable value of by products should be ascertained and it should be deducted from the cost of the main product.

An asset is a resource controlled by an enterprise as a result of past events from which the future economic benefits are expected. As per AS 2, inventories are assets (a) held for sale in the ordinary course of business (b) in the process of production for such sale (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services. As the inventory of by-product is a resource controlled by T Ltd., it is an asset and it is inventory because it is held for sale in the ordinary course of business.

Hence, T Ltd. should deduct the realizable value of its by products from the cost of production of main product.

(d) As per **AS-13 "Accounting for Investments"** issued by the Institute of Chartered Accountants of India, long-term investments are usually of individual importance to the investing enterprise. The carrying amount of long-term investments is therefore determined on an individual investment basis. Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognize a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

Keeping in view the above, K Ltd should provide for the decline in the value of investments in two subsidiaries despite the fact that the overall investment portfolio in subsidiaries did not suffer any decline.

Question 5

As a statutory auditor of a company, comment on the accounting policy on Revenue Recognition for a company engaged in manufacture and sale of chemical products was stated as "Revenue is recognized only when it can be reliably measured and it is reasonable to expect ultimate collection".

Answer

Revenue Recognition: As per AS 9 Revenue Recognition, in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) 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

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

Therefore, revenue from sales transactions should be recognised when the requirements as to performance set out above is satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim uncertainty regarding collection exist, then revenue recognition should be postponed.

In the instant case, the company is engaged in manufacturing and sale of chemical products, and made disclosure in accounting policy on recognition of revenue as per AS 1 stating that revenue is recognized only when it can be reliably measured and it is reasonable to expect ultimate collection, is correct. However, accounting policy disclosed above should also cover the aspect of transfer of risk and reward for the purpose of revenue recognition.

Question 6

Comment "M/s. PQR has been appointed the sole statutory auditor of a large company for 2013-14, where till last year M/s. LMN was also one of the joint auditors along with M/s. PQR. Mention the steps that should be taken by M/s. PQR before commencing the audit".

Answer

Steps before Commencing the Audit Work: When one of the joint auditors of the previous year is considered for ratification by the members as the sole auditor for the next year, it is similar to non re-appointment of one of the retiring joint auditors. The provisions of section 140 of the Companies Act, 2013 (hereinafter referred as the Act) relating to non-reappointment of the retiring auditor need to be considered. As per sub-section 4 of section 140 of the Act, special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or, as the case may be, ten years, as provided under sub-section (2) of section 139 of the Act.

The following steps should be taken care of by M/s. PQR before commencing the audit:

(i) Ascertain that special notice under Section 140(4) of the Act was duly received by the company, from such number of members holding not less than one percent of total voting power or holding shares on which an aggregate sum of not less than five lakh rupees has been paid up on the date of the notice, not earlier than three months but at least 14 days before the AGM date as per Section 115 of the Act read with rule 23(1) and 23(2) of the Companies (Management and Administration) Rules, 2014.

(ii) Check whether the said notice has been sent to all the members at least 7 days before the date of the AGM as per Section 115 of the Act read with rule 23(3) of the Companies (Management and Administration) Rules, 2014.

(iii) Verify the notice contains an express intention of a member for proposing the resolution for appointing a sole auditor in place of both the joint auditors who retire at the meeting but are eligible for re-appointment.

(iv) Verify that the said notice is also sent to the retiring auditor as per Section 140(4)(ii) of the Act.

(v) Verify whether any representation received from the retiring auditor was sent to the members of the company to whom notice of the meeting was sent as per Section 140(4)(iii) of the Act.

(vi) Verify from the minutes book whether the representation received from the retiring joint auditor was considered at the AGM.

(vii) Examine that proposed resolution was properly passed.

Further, Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts a position as auditor previously held by another chartered accountant without first communicating with him in writing. Moreover, Clause (9) of Part I of the same Schedule, 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 (now Section 139 and 140 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

Therefore, M/s PQR is required to comply with all the above mentioned provisions provided under Companies Act and Chartered Accountant Act before commencing the audit.

Question 7

A Ltd is a manufacturer of readymade garments. It sells its products to franchisees located across the country. Readymade garment industry is subject to change in trends of fashion and as such, some of the goods are returned and A Ltd accepts them back as sales returns. On the basis of past trends such returns are estimated to be at 20% of the sales of any year. For the financial year 2013-14, A Ltd had accounted for the actual sales return made upto 31st March 2013 but has not reversed the possible expected return that are likely to happen after 31st March 2014, in respect of the sale made for the FY 13-14. Mr. X the auditor of A Ltd wants this to be considered in the accounts for the year ended on 31st March 2014 but the company is of the opinion that although there is a probability of some goods being returned by the franchisees, there is no significant uncertainty regarding the amount of consideration that will be derived from the sale of goods, since the goods are not in the possession of the company and risk and rewards of ownership still lie with the franchisees and the company cannot record sales returns in its books of account in respect of goods that are likely to be received after the date of balance sheet. Comment.

Answer

Recognition of Revenue: AS 9 on 'Revenue Recognition', states that revenue from sale of goods should be recognised when the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership and no significant uncertainty exists regarding the amount of consideration.

Further, revenue recognition is mainly concerned with the timing of recognition of revenue in statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by the agreement between the parties involved in the transaction. When

uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

In the present case, A Ltd. is a manufacturer of readymade garments and sells its products to franchisees located across the country. Due to change in trends of fashion etc sold goods are being returned and A Ltd. accepts them back as sales returns. On the basis of past trends such returns are estimated as 20% of the sales of any year.

In this case, the company is bearing the risk of sales return and therefore, the company should not recognize the revenue to the extent of 20% of its sales. The company may disclose suitable revenue recognition policy in its financial statements separately.

In the absence of the above, the auditor must qualify his report.

Note: Alternative Answer is possible on the basis of AS 29 on Provisions, Contingent Liabilities and Contingent Assets by recognising the whole sales as revenue, i.e., 100% accounted in Statement of Profit and Loss as sales Income as there is no significant uncertainty regarding the amount of consideration. However, keeping in view its past performance, A Ltd. should 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.

Question 8

Comment on the following:

(a) MRE Ltd. provided ₹ 25 lakhs for Inventory obsolence in 2013-14. In the subsequent years, it was determined that 50% of such inventory was usable. The Board of Directors wants to adjust the same through prior period adjustment.

(b) SRS Ltd. has drawn the financial statement as on 31-3-14 and presented to you alongwith additional information:

Balance Sheet of SRS Ltd. as on 31-3-14

Liabilities	*Amt.*	*Assets*	*Amt.*
Share capital	*50,00,000*	*Fixed Assets*	
Reserves & Surplus		*Gross block*	
Statement of Profit and Loss	*4,00,000*	*Less: Depreciation*	*1,00,00,000*
Secured Loans	*75,00,000*	*Investments*	*Nil*
Current Liabilities and		*Current Assets*	
Provisions		*Loans & Advances*	
Trade Payables	*3,00,000*	*Trade Receivables*	*25,00,000*
Advance received	*3,00,000*	*Advance Paid*	*10,00,000*
	1,35,00,000		*1,35,00,000*

Additional Information:

(a) Entire pre-operative expenses of ₹ 7,00,000/- was charged to Statement of Profit and Loss whereas for the purpose of Income Tax, only what is allowable is claimed.

(b) Depreciation as per Books - ₹ 35,00,000/-

Depreciation as per Income tax - ₹ 50,00,000/-

(c) Losses to be carried forward as per Income Tax Act - ₹ 16,00,000/-

(d) Donation disallowed while computing tax - ₹ 50,000/-

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

(c) ABC & Co. and DEF & Co, Chartered Accountant firms were appointed as joint auditors of Good Health Care Ltd. for 2013-14. A special audit was conducted during March 2014 and observed gross understatement of Revenue. The revenue aspects were looked after by DEF & Co, but there was no documentation for the division of work between the joint auditors.

Answer

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

An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

A change in an accounting estimate may affect the current period only or both the current period and future periods. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

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

In this case, MRE Ltd. provided ₹ 25 lakhs for inventory obsolescence in 2013 - 14. In the subsequent year due to change in circumstances, it was determined that 50% of such inventory was usable. Revision of such an estimate does not bring the resulting amount of ₹ 12.5 lakhs within the definition either of a prior period item or of an extraordinary

item. The amount, however, involved is material and requires separate disclosure to understand the financial position and performance of an enterprise. Accordingly, adjustment in the value of the inventory through prior period item would not be proper.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Question 9

A infrastructure company has constructed a mall and entered into agreement with tenants towards license fees (monthly rental) and variable license fees, a percentage on the turnover of the tenant (on an annual basis). Chief Finance Officer wants to account/recognize license fee as income for 12 months during current year under audit and variable license fees as income during next year, since invoice is raised in the subsequent year. As an auditor, how would you deal and state in the statement of Accounting policies?

Answer

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 Statement of Profit and Loss does not exhibit a true and fair view of the profit or loss.

Question 10

(a) In the course of audit of T Ltd. you observed that export incentives are not accounted on accrual basis. The company's management contended that these would be accounted on cash basis citing the uncertainty about its receipts as they are not admitted as due by the customs authorities. Comment.

(b) Z Ltd. has flexi deposit linked current account with various banks. Cheques are issued from the current account and as per the requirements of funds, the flexi deposits are encashed and transferred to current accounts. As of 31st March, 2014 certain cheques issued to vendors are not presented for payment resulting in the credit balance in the books of the company. The management wants to present the book overdraft under current liabilities and flexi deposits under cash & bank balances. Comment.

Answer

(a) 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 T 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 does 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 T Ltd. has to account the export incentives on Accrual basis.

(b) Presentation of Book Overdraft as per Schedule III to the Companies Act, 2013: The instructions in accordance with which current assets being "cash and cash equivalents" should be made out to Part I of Schedule III to the Companies Act, 2013 states as follows:

(i) Cash and cash equivalents shall be classified as:

(a) Balances with banks;

(b) Cheques, drafts on hand;

(c) Cash on hand;

(d) Others (specify nature).

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months maturity shall be disclosed separately.

From the facts of the case it is evident that in substance the position is that the composite bank balance including the balance in flexi deposit accounts are positive, even though physical set-off has not been made as on the balance sheet date. Further the bank has got the right to set off of flexi deposits against the cheques issued and hence it would be more informative and useful to the readers of the financial statements to disclose the book credit balance as a set-off from the flexi deposit accounts. The disclosure of the said book credit balance as book overdraft under the head current liabilities as proposed by the management is not correct.

Question 11

Comment on the following:

(a) B Co. Ltd. is engaged in the business of developing mass scale housing projects including development of small commercial complexes. The flats/commercial spaces are booked by the public and are allotted by way of allotments letter to each allottee. Major construction activities pertaining to buildings are undertaken after allotment is over. After completing the construction, possession of flats/commercial spaces is given to allottees by executing legal document. The CEO of the B Co. Ltd. says that AS 7 is not applicable to the company.

(b) In the notes to accounts of C Co. Ltd. as on 31-03-2014 Note no. 11 states that 'Certain machinery items are lying at customs warehouses and company has paid ₹ 900 lakhs up to 30-06-2013 as detention charges, out of which a sum of ₹ 580 lakhs is written back during the year 2013-14 based on settlement with the concerned authorities in respect of a major spares of machinery. For the remaining machinery items negotiations are

pending and a provision of ₹ 44 lakhs is made. As such total amount of ₹ 364 lakhs paid/provided on account of detention charges have been capitalized and included in the Fixed Assets/Capital work in progress. The management is of the view that these expenses are directly attributable to the acquisition of the related Fixed Asset.

(c) During the course of audit of D Co. Ltd. you as an auditor have observed that Inter Corporate deposit of ₹ 50 lakhs has been overdue. The D Co. Ltd. have disclosed this in the notes to accounts note No. 15 in schedule no. 21 stating that ₹ 50 lakhs is overdue from XYZ Co. Ltd. and the said company is in the process of liquidation. The management is taking steps to appoint the liquidator.

Answer

(a) Applicability of AS 7: 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".

(b) Accounting for Fixed Assets lying at Custom Warehouses: 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 Statement of Profit and Loss shows true and fair profit of the year ending on 31-3-2014. 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 Statement of Profit and Loss. 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."

(c) 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.

Question 12

Mr. Ram, a relative of a Director was appointed as an auditor of the company. Comment.

Answer

Appointment of the Auditor: Section 141 of the Companies Act 2013 (herein after referred as the Act) deals with the eligibility, qualifications and disqualifications of Auditors. Sub-section (3)(f) of the Section 141 of the Act, explicitly disqualifies a person from being appointed as an auditor of a company whose relative is a director or is in the employment of the company as a director or key managerial personnel.

According to the code of ethics there is no direct restriction on a member to accept the audit of a company where his relative is director. Further, as per Clause 4 of Part 1 of the Second Schedule to the Chartered Accountants Act, 1949 there is professional misconduct if the member expresses his opinion on financial statements of any business or enterprise in which he, his firm or a partner in his firm has a substantial interest. Here also there is no mention of relative. But this clause has been inserted for the purpose of ensuring the independence of the auditor so that his opinion on the financial statements is an independent opinion free of any interest.

In August 2008 the council has issued a guideline in this respect. As per that guideline a member of the institute shall desist from expressing his opinion on financial statements of any business or enterprise in which one or more persons, who are relatives within the meaning of section 6 of the Companies Act, 1956 (now Section 2(77) of the Companies Act, 2013), have either by way of themselves or in conjunction with such members, a substantial interest in the said business or enterprise. Therefore if the director has substantial interest in the company then his relative should not accept the appointment of auditor of that company.

In the instant case, Mr. Ram is the relative of a Director of the Company, therefore he should not accept the appointment as an auditor of that company.

Question 13

While doing the audit, X, the Statutory Auditor of ABC Ltd. observes that certain loans and advances were made without proper securities, certain trade receivables and trade payables were adjusted inter se, and personal expenses were charged to revenue. Comment.

Answer

Audit Report: Section 143(1) of the Companies Act, 2013 requires the auditor to make an enquiry in respect of specified matters during the course of his audit. Since the law

requires the auditor to make an enquiry, the Institute opined that the auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. It is to be noted that the auditor is required to make only enquiries and not investigate into the matters referred to therein.

Clause (a) of Section 143(1) requires the auditor to inquire: "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 prejudicial to the interests of the company or its members".

If the auditor finds that the loans and advances have not been properly secured, he may enter an adverse comment in the report but cannot probably doubt the true view of the accounts by reference to this fact so long the loans and advances are properly described and presented in terms of Part I of Schedule III to the Companies Act. Further the auditor to inquire whether or not the terms on which the loans or advances have been made are prejudicial to the interests of the company or its members. If it is, he should qualify his report.

If trade receivables and trade payables are adjusted inter se, this amounts to merely book entries. The auditor, as per clause (b) of section 143(1), should enquire "whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company". This proposition has got to be inquired into by reference to the effects of the book entries, unsupported by transactions, on the legitimate interests of the company. The auditor has to exercise his judgment based on certain objective standards".

Regarding Personal Expenses, Clause (e) of section 143(1) requires the auditor to inquire: "Whether personal expenses have been charged to revenue account". The charging to revenue of such personal expenses, either on the basis of the company's contractual obligations, or in accordance with accepted business practice, is perfectly normal and legitimate or does not call for any special comment by the auditor. Where, however, personal expenses not covered by contractual obligations or by accepted business practice are incurred by the company and charged to revenue account, it would be the duty of the auditor to report thereon. It suffices to say that if the auditor finds that personal expenses have been charged to revenue and if the amounts are material, he should qualify his report also.

In the instant case, Mr. X, the statutory auditor of ABC Ltd., needs to enquire in light of above provisions, as a result of the enquiries if he is satisfied then there is no further duty to report on these matters.

Question 14

Comment on the following:

(a) T Ltd. an Indian company, subject to Indian Income tax Act, 1961, discloses advance Income-tax paid (Current tax asset) and provision for Income-tax (Current tax liability), separately in Balance Sheet for the year ended 31.3.2014, i.e., it does not offset the amount.

(b) F Limited includes in the Schedule of Inventory, those items of Fixed Assets which have not been in active use and held for disposal, as inventory item.

Answer

(a) Offsetting Assets and liabilities: As per paragraph 27 of Accounting Standard (AS) 22– "Accounting for Taxes on Income", an enterprise should offset assets and liabilities representing current tax if the enterprise:

(i) has a legally enforceable right to set off the recognized amounts and

(ii) intends to settle the asset and liability on a net basis.

An enterprise will normally have a legally enforceable right to set off an asset and liability representing current tax when they relate to income taxes levied under the same governing taxation laws and the taxation laws permit the enterprise to make or receive a single net payment.

Since T Ltd is an Indian Company, and as per Income Tax Act, 1961, such set off is allowed which is legally enforceable. Thus, in view of Provisions of AS 22 and Income Tax Laws, T Ltd. should offset advance tax paid against provision for income tax and show only the net amount in the balance sheet.

(b) Accounting for Fixed Assets held for disposal: 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, F 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.

Question 15

Dark Ltd. has received a grant of ₹ 20 lacs under the Government's Subsidy Scheme for acquiring an imported machinery for setting up an oil exploration plant and the entire grant received is credited to Statement of Profit and Loss.

Answer

Accounting for Government Grants: 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 Statement of Profit and Loss 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 Statement of Profit and Loss on a systematic and rational basis over the useful life of the asset. By crediting the entire amount of grant to the Statement of Profit and Loss, 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.

Question 16

X Ltd. did not follow the applicable Accounting Standard for disclosing Earnings Per Share (EPS) in the financial statements. The fact of such non-disclosure was however, mentioned in the notes forming part of accounts. As the statutory auditor of X Ltd., how would you report in the above case?

Answer

Disclosure of EPS is required for all companies as per AS 20 "Earnings per Share". AS 20 is also one of the AS notified by Section 133 of the Companies Act, 2013 read with the clarification given by the Ministry of Corporate Affairs (MCA) vide General Circular that the existing Accounting Standards notified under the Companies Act, 1956 shall continue to apply till it is prescribed by Central Government.

If the disclosures required by AS 20 are not made, it is the duty of the auditor to qualify in his report "Whether Accounting Standards under the clause as notified u/s 129(1) have been followed?" Mere disclosure by company in notes does not absolve him of his duty.

The same is, however, not a qualification to affect the "True & Fair" position of financial results of the company.

Question 17

X Ltd., paid ₹ 25 lakhs as advance to Y Ltd. towards the purchase of a printing machinery on 15.1.14 with delivery instructions to deliver the same in the last week of June, 14. Further on 2.2.14 X Ltd. purchased two diesel generator sets from Y Ltd. for ₹ 30 lakhs on 90 days Credit term. In the accounts for 2013-14, X Ltd. intends to adjust the advance paid against Credit purchase and show the net amount of ₹ 5 lakhs as due from them. As the statutory auditor, how would you deal with this?

Answer

Adjustment of Advances: Since X Ltd. has paid advance amount to the supplier of machinery to be used in the project, such advance amount should be grouped under the head 'Capital Work in Progress'. This is as per requirement of Schedule III to the Companies Act, 2013 and the existing accounting practice.

If the advance is for purchase of other machinery, it should be grouped under a separate head – say 'Advance Payment for Capital Expenditure' and should be disclosed as next item to Fixed Assets in the Balance Sheet.

In view of the above, the proposal of X Ltd., to show the net balance in the personal account of Y Ltd., is not correct. Such proposal will conceal the two material items in the balance sheet – one, expenditure towards capital asset and the other current liability for purchase of the generator set.

Hence, the auditor should advise X Ltd. to show these two items separately. If X Ltd. does not accept the advice, the auditor should qualify his report with suitable quantification of amount involved.

Question 18

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

Answer

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

1. ***Check whether the dividend was declared out of profits arrived at after providing for depreciation as per Section 123(2) of the Companies Act, 2013 (herein after referred as the Act).***
2. ***Check whether-***
   - ***(i) the depreciation was provided according to provision of Schedule II to the Act.***
   - ***(ii) a board resolution recommending dividend was passed.***
   - ***(iii) the dividend was declared only in the Annual General Meeting.***
   - ***(iv) no dividend declared in general meeting exceeds the amount recommended by the Board.***
   - ***(v) amount paid or credited as paid on a share in advance of calls is not treated for the purpose of this regulation as paid on the share.***
   - ***(vi) register of members was closed as per the provisions of section 91 of the Act.***
   - ***(vii) dividend has been paid in the prescribed manner within 30 days of time to the registered holder or their order for the compliance of Section 127 of the Act.***
   - ***(viii) Amount of dividend deposited in a separate bank account within five days from the date of declaration of dividend.***
   - ***(ix) intimation sent to Stock Exchange in the case of listed company.***
   - ***(x) were there any complaints of non-payment/delayed payment of dividend? If so, whether corrective action was taken.***

Question 19

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

(a) While adopting the accounts for the year, the Board of Directors of Sunrise Ltd. decided to consider the Interim Dividend declared @15% as final dividend and did not consider transfer of Profit to reserves.

(b) V Ltd. sold 1 lakh vacuum pumps during the year 2013-14 with a condition to make good by repair/replacement any manufacturing defects reported within 6 months from the date of sale. Past experience in this regard showed that there were no replacements carried out, but minor/major repairs were necessitated to the extent of 10%/5% respectively of the units sold. The cost of such minor/major repairs would amount to ₹ 1,000/₹ 6,000 respectively. While finalizing the accounts for the year, the company does not reflect any provision, in this regard.

(c) XYZ Pvt. Ltd., manufacturing garments, has valued at the year end its closing inventory of packed finished goods for which firm export contracts have been received, at realizable value inclusive of profit and export cash incentive. As at the year end, the ownership of the goods has not been transferred to the foreign buyers.

Answer

(a) ***Declaration of Interim Dividend: Section 123(3) of the Companies Act, 2013 provides that the Board of Directors of a company may declare interim dividend during any financial year out of the surplus in the Statement of Profit and Loss and out of profits of the financial year in which such interim dividend is sought to be declared. The amount of dividend including interim dividend should be deposited in a separate bank account within five days from the declaration of such dividend for the compliance of Section 123(4) of the said Act.***

Based on Section 2(35) of the said Act, it can be said that since interim dividend is also a dividend, companies should provide for depreciation as required by Section 123 before declaration of interim dividend. However the first proviso to Section 123(1) provides that a company may, before the declaration of any dividend in any financial year, transfer such percentage of its profit for that financial year as it may consider appropriate to the reserves of the company irrespective of the size of the declared dividend i.e. the company is not mandatorily required to transfer the profit to the reserves, it is an option available to the company to transfer such percentage.

In the instant case, the Board has decided to pay interim dividend @15% of the paid-up capital. Assuming that the company has complied with the depreciation requirement, the interim dividend can be declared without transferring such percentage of its profits as it may consider appropriate to the reserves of the company.

(b) Provisions: As per AS – 29, 'Provisions, Contingent Liabilities and Contingent Assets', a provision is a liability which can be measured only by using a substantial degree of estimation.

As per AS – 29, a provision should be recognised when:

1. An enterprise has a present obligation as a result of a past event;
2. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
3. A reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

In the present case, V Ltd. fulfils all the above conditions. The sale of pumps with a warranty obligation constitutes the present obligation as a result of past event. It is probable that some outflow will be involved in setting the warranty obligation, satisfy the second condition. As per the details based on past precedence reliable estimate can be made as under:

[6000 × (5% of 100000) + 1000 × (10% of 100000)] = ₹ 400 lakhs

Thus, V Ltd. as on 31.3.07 should make a provision for warranty obligation against sale of vacuum pumps to the extent of ₹ 400 lakhs. The auditor should insist on such provision being created. If provision is not made he should qualify his audit report.

(c) Valuation of Inventories: AS 2 requires that inventories should be valued as lower of cost and Net realisable value (NRV). A departure from the general principle can be made if the AS is not applicable or having regard to the nature of industry.

AS 2 also states that (a) work in progress arising under construction contracts, including directly related service contracts (b) work in progress arising in the ordinary course of business of service providers;(c) shares, debentures and other financial instruments held as stock-in-trade; and(d) producers' inventories of livestock, agricultural and forest products are measured as NRV based on established practices.

In the given case, the sale is assumed under a forward contract but the goods are not of a nature covered by the above exceptions. Taking into account the facts the closing inventory of finished goods should have been valued at cost, as it is lower than the realisable value (as it includes profit). Further, export cash incentives should not be included for valuation purposes.

The policy adopted by the company for valuing its closing inventory of finished goods on selling price plus export incentives is not correct. The statutory auditor should give a qualified report.

Question 20

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

Answer

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

1. ***Ceiling limit: Ensure that a certificate has been issued under section 139 of the Companies Act, 2013 so that the total number of company audits held by the firm (including the new appointment) will not exceed the specified number.***
2. ***Resolution at AGM: Verify that at AGM of the Company, a proper resolution is passed. Inspect general meeting minutes book to see that the appointment is duly recorded.***
3. ***Compliance with law: Satisfy that the legal procedure contemplated in section 139 and 140 of the said Act, dealing with the appointment and removal of existing auditor, have been followed. Also check whether section 139(5) and 139(7) (in case of a government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments- appointment by the Comptroller and Auditor General of India) are attracted and complied with.***
4. ***Code of conduct: Communicate with the previous auditor, if any, in writing, to ascertain if there are any professional reasons for not accepting the appointment.***

Question 21

Write short notes on the following:

(a) Key Management Personnel

(b) Normal Capacity for the purpose of Inventory valuation

(c) Integral Foreign Operations

Answer

(a) Key management personnel: As per AS 18 on Related Party Disclosures, "Key management personnel" are those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

Further, Section 2(51) of the Companies Act, 2013 also defines the "key managerial personnel" in relation to a company as the Chief Executive Officer or the managing director or the manager; the company secretary; the whole-time director; the Chief Financial Officer; and such other officer as may be prescribed.

It may be noted here that non-executive directors of a company will not be considered as key management personnel under AS 18 by virtue of merely their being directors, unless they have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

Further, the requirements of AS 18 should not be applied in respect of a non-executive director even if he participates in the financial and/or operating policy decision of the enterprise unless he falls in any of the categories discussed in Para 3 of AS 18.

(b) Normal capacity for inventory valuation: As per AS 2 on Valuation of Inventories, allocations of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities.

Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. Due to this, the fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. In periods of high production, these overheads allocated are decreased so that inventories are not measured above cost.

(c) Integral Foreign Operations: As per AS 11 on The Effects of Changes in Foreign Exchange Rates, there are foreign operations, the activities of which are an integral part of the reporting enterprise. This is important since the method used to translate financial results of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise.

A foreign operation that is integral to the operation of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. In such cases, change in exchange rates between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rates affects the individual monetary items held by the foreign operation rather than the net investment in that operation.

Question 22

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

(a) A company capitalises interest on borrowings incurred for holding investments by adding the same to the cost of investment every year.

(b) X Ltd. is engaged in manufacture of Cement. In the Statement of Profit and Loss for the year ended 31st March, 2014, it discloses its revenue from sales transactions (turnover) net of excise duty. The excise duty collected and paid on sales transactions and that related to difference between Closing inventory and Opening inventory is, however, disclosed in the "Notes to Accounts".

Answer

(a) Capitalisation of Interests: Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. As per AS-13 "Accounting for Investments", cost of investments includes acquisition charges such as brokerage, fees and duties. As per AS 16 "Borrowing Costs", borrowing costs that are directly attributable to the acquisition,

construction or production of a qualifying asset should be capitalized as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Assets that are ready for their intended use or sale when acquired are not qualifying assets. Therefore such investment is not a qualifying asset, therefore interest cost of holding investments cannot be capitalized.

(b) Disclosure requirement of Excise Duty: As per Accounting Standard Interpretation – ASI 14 ' Disclosure of Revenue from Sales Transactions' (Revised) issued by ICAI in Aug 2006, the amount of turnover should be disclosed as follows on the face of the Statement of Profit and Loss:

Turnover (Gross)	XX
Less : Excise duty	XX
Turnover (Net)	XX

Further, the excise duty shown above should be the total duty except the duty related to the difference between closing inventory & opening inventory which should be recognized separately in the Statement of Profit and Loss, with an explanatory note in the notes to accounts to explain the nature of the two amounts of excise duty.

Since the company, X Ltd has not followed the above ASI 14, the auditor would have to qualify his report accordingly.

Question 23

Write short notes on Purchase method of Accounting for amalgamations.

Answer

Purchase method of Accounting for Amalgamation: As per AS 14 on Accounting for Amalgamations, there are two main methods of accounting for amalgamations i.e. the pooling of interests method and the purchase method. Under the purchase method in preparing the transferee company's financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company. Any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve. The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortization period should not exceed five years unless a somewhat longer period can be justified. Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company. The corresponding debit should be given to a suitable account head (e.g., 'Amalgamation Adjustment Account') which should be disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account should be reversed.

Question 24

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

(a) In the audit of ABC Private Limited, auditor came across cases of payments to Directors, whereby, expenses of a personal nature were re-imbursed.

(b) The management of a limited company states that proposed dividend does not represent a liability and hence no provision need to be made-Comment.

Answer

(a) Reimbursement of personal expenses of Director: All payments to Directors as remuneration or perquisites whether in the case of a public or private company are required to be authorised both in accordance with the Companies Act and Articles of Association of the company. Articles may provide that such remuneration require sanction of the shareholders either by ordinary or special resolution while in some cases it may require only approval of Directors. If the terms of appointment of a Director include payment of expenses of a personal nature, then such expenses can be incurred by the company; otherwise, no such expense can be incurred or reimbursed by the company. In the instant case the auditor has to ensure that the above is complied with, without which, if such expenses are paid, he has to disclose the fact in his report, as also in the accounts. In this regard attention is invited to section 143(1)(e) of the Companies Act, 2013 wherein auditor has to inquire into whether personal expenses have been charged to revenue.

(b) Provision for Proposed Dividend: The Schedule III to the Companies Act, 2013, requires disclosure of the amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share to be disclosed separately. It also requires separate disclosure of the arrears of fixed cumulative dividends on preference shares.

Further, as per AS 4 "Contingencies and Events Occurring After the Balance Sheet Date", there are events which, although take place after the balance sheet date are sometimes reflected in the financial statement because of Statutory requirement or because of their special nature and such item includes the amount of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered in the financial statements.

Hence, a question that arises is as to whether this means that proposed dividend is not required to be provided for when applying the Schedule III.

Keeping this in view and the fact that earlier the disclosure of provision for proposed dividend was statutory requirement as per Old Schedule VI to the Companies Act, 1956, hence it was an adjusting event as per AS 4 and was provided for. However, this statutory requirement has been changed to disclosure by way of notes as per Schedule III to the Companies Act, 2013. Therefore, provision for proposed dividend is a non-adjusting event.

In the instant case, management of the company states that the proposed dividend does not represent a liability hence, no entry has been passed in the books of the company. Contention of the directors for non provision as per Schedule III is correct since statutory compliance has been changed. Consequently, amount of proposed dividend should be disclosed by means of a note to the accounts.

Question 25

Apex Ltd., a well reputed manufacturing public limited company has made a contribution of ₹ 2.5 lacs during the financial year ended 31.3.14 to a political party for running a school, situated in the village, where most of the workers of the company reside. It is admitted that the benefit of the school is mostly for the children of the workers of the company. The company has not made any profits in the last four years.

Answer

Restrictions regarding political contribution: Section 182 of the Companies Act, 2013 deals with prohibitions and restrictions regarding political contributions. According to this section, a government company or any other company which has been in existence for less than three financial years cannot contribute any amount directly or indirectly to any political party. In other cases, contribution in any financial year should not exceed 7½ % of average net profits during the three immediately preceding financial years. The company in question has not made any profit in last four years and contributed ₹ 2.5 lacs during the year to a political party for running a school. This is violation of the provisions of Section 182 of the said Act although the children of its workers are benefited. The auditor would have to qualify his report stating the contravention of the provisions of the Companies Act.

Question 26

Write short notes on Effect of uncertainties on revenue recognition.

Answer

Effect of uncertainties on Revenue recognition: Para 9 of AS 9 "Revenue Recognition" deals with the effect of uncertainties on revenue recognition. The Para states:

(i) Recognition of revenue requires that revenue is measurable and at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.

(ii) Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g. for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases it may be appropriate to recognize revenue only when it is reasonably certain that the ultimate collection will be made. When there is no uncertainty as to ultimate collection, revenue is recognized at the time of sale or rendering of service even though payments are made by instalments.

(iii) When the uncertainty relating to collectability arises subsequent to the time of sale or rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

(iv) An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

(v) When recognition of revenue is postponed due to effect of uncertainties, it is considered as revenue of the period in which it is properly recognised.

Question 27

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

(a) A Pvt. Ltd., started stock broking activities in 2014. For this purpose it acquired membership of a stock exchange for ₹ 110 lacs. While finalizing the accounts, the company disclosed the above amount under the Fixed Assets schedule as "Stock Exchange Membership Rights". The company also did not write off any amount since the rights would enable the company to perpetually carry on its business.

(b) XYZ Ltd. had received a grant of ₹ 50 lacs in 2006 from a State Government towards installation of pollution control machinery on fulfillment of certain conditions. The company, however, failed to comply with the said conditions and consequently was required to refund the said amount in 2014.

The company debited the said amount to its machinery in 2014 on payment of the same. It also reworked the depreciation for the said machinery from the date of its purchase and passed necessary adjusting entries in the year 2014 to incorporate the retrospective impact of the same.

(c) C Ltd. holds shares of D Ltd. which also entitles it to 51% voting power. These shares are held as "Stock-in-Trade" since C Ltd.'s intention is to dispose them in the near future. Due to this, C Ltd. is of the view that the financial statements of D Ltd. need not be consolidated.

Answer

(a) Stock Exchange Membership Rights: A Pvt. Ltd. has paid ₹ 110 lacs for acquiring membership of stock exchange. Such membership rights provide exclusive right to A Pvt. Ltd. for carrying out stock broking activities. Thus, Stock Exchange Membership Rights are controlled by A Pvt. Ltd. and provide the basis for generating economic benefits to it. All these criteria appear to meet the definition of intangible assets as laid down in AS 26, "Intangible Assets". The Standard requires an entity to recognize an intangible asset if it

is probable that the future economic benefits that are attributable to the asset will flow to the enterprise and the cost of the asset can be measured reliably. In the instant case, membership rights of stock exchange acquired by A Pvt. Ltd. meet the criteria of identifiability, control and arising of future benefits as well as reliability of the amount of cost. Thus recognizing the membership rights as Fixed Assets is proper.

However, the fact that the company did not write-off any amount since it would enable the company to perpetually carry on its business is not proper since AS 26 requires that all Intangible Assets to be amortised. For this purpose, a rebuttable presumption of 10 years is to be considered. Hence in the instant case, the company should have amortised such rights over 10 years. Since the company has not amortised any amount, the auditor will have to qualify his report and state the fact of non-compliance with AS 26.

(b) **Refund of Government Grant:** As per facts of the case, XYZ Ltd. had received a grant of ₹ 50 lacs in 2006 from a State Government towards installation of pollution control machinery on fulfilment of certain conditions. However, the amount of grant has to be refunded since it failed to comply with the prescribed conditions. In such circumstances, AS 12, "Accounting for Government Grants", requires that the amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. The Standard further makes it clear that in the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset. Accordingly the accounting treatment given by XYZ Ltd. of increasing the value of the plant and machinery is quite proper. However, the accounting treatment in respect of depreciation given by the company of adjustment of depreciation with retrospective effect is improper and constitutes violation of both the AS 6, "Depreciation Accounting" and AS 12, "Accounting for Government Grants".

The auditor, therefore, should discuss with the management to make necessary changes in respect of same and if not agreed to, qualify the report quantifying the impact of the same on profit as well as assets of the company.

(d) **Consolidation of Accounts:** AS 21, "Consolidated Financial Statements", requires that a subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future. In this case it needs consideration as to whether C Ltd.'s intention is to dispose off shares or hold the same. Since shares are being held as 'stock-in-trade' and the intention is to dispose off in near future, it is quite clear that control is temporary. Accounting Standards Interpretation issued by the Institute of Chartered Accountants of India specifies that where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise would be considered temporary. Hence, in such a case, the concerned subsidiary should be excluded from consolidation. Therefore, the contention of the C Ltd. that D Ltd. can be excluded from consolidation is correct.

Question 28

Write short notes deferred taxation.

Answer

Deferred Taxation: AS 22 "Accounting for Taxes on Income", prescribes the accounting treatment for taxes on income. The amount of taxable income for a period and the amount of profit (or loss) as shown by the Statement of Profit and Loss for that period are seldom the same. The difference between accounting income and taxable income arise due to the fact that taxable income is calculated in accordance with tax laws whose requirements regarding computation of taxable income differ from the accounting policies applied to determine accounting income. The difference between taxable income and accounting income can be classified into 'permanent differences' and 'timing differences'. 'Permanent differences' are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently. Timing differences, on the other hand, are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. The standard requires that deferred tax should be recognized for all timing differences, subject to the consideration of prudence in respect of deferred tax assets. Deferred tax represents the future tax effects of timing differences. Some timing differences are such that their reversal in future year(s) would result in the taxable income for the year(s) of reversal being higher than the accounting income for that year (or those years).

Question 29

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

(a) ABC Ltd. commenced construction of a flyover in Mumbai in January, 2013 under BOLT scheme. The same was completed in February, 2014. Due to seasonal heavy rains in July, 2013 in the area, the work on the flyover had to be suspended for 1 month. The company accordingly suspended borrowing costs of ₹ 12.50 lakhs for that month from capitalization.

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

(c) LM Ltd. has 2 divisions L and M. The finished products of division L are transferred to division M where further processing is carried out before sale to customers. To achieve transparency and accountability between the divisions, division L raises an invoice on division M at cost plus normal margins. At the year end the unrealized profits on inter-division inventories are eliminated. However, the transfers are recorded at the invoice value as sales and purchases in the respective divisions for the purpose of preparing the Statement of Profit and Loss. Suitable disclosures, for this are given in then 'Notes to Accounts'.

(d) T Pvt. Ltd. is an unlisted closely held company with turnover less than ₹ 50 crores. While finalizing the accounts, Mr. M the Director (finance) disputed the applicability of AS 20 to the company.

Answer

(a) Capitalisation of Borrowing Costs: Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for intended use or sale are interrupted. According to AS-16, "Borrowing Costs", capitalisation of such borrowing costs should be suspended during extended periods in which active development is interrupted. The standard, however, clarifies that capitalisation of borrowing costs is not suspended when a temporary delay is necessary as a part of the process or substantial technical and administrative work is being carried out. Thus, the test as to whether or not to capitalise the borrowing costs depends primarily upon the nature of interruption of activities during "extended periods".

In the instant case, it has been mentioned that the construction activity was interrupted due to seasonal rain and hence being regular feature. Though the rain was heavy, the period cannot be considered as an "extended period" leading to substantial delay in suspension of construction activities. Therefore, borrowing cost of ₹ 12.50 lakhs incurred by ABC Ltd. should be capitalized. Hence, suspension of capitalization by the company is not a correct treatment and statutory auditor should report accordingly.

(b) Branch Auditor's Report: As per provisions of the Companies Act, 2013, the accounts of a branch office of a company are required to be audited either by the company's auditor or by any other person qualified for appointment as auditor of the company. It is not necessary for branch auditor M/s XYZ to visit the branch and conduct the audit only at branch's premises. It is a matter of professional judgement for the branch auditor to decide as to whether he needs to visit the branch. At the same time, the statutory auditor has the right to visit branch offices and to have access to the books of accounts and vouchers maintained at the branch office in this case.

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

(c) Revenue Recognition: As per the definition of the term "Revenue" in AS 9, "Revenue Recognition", revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them.

As per the clarification issued by ICAI, the use of the word "enterprise" in the above definition clearly implies that the transfers within the enterprise cannot be considered as fulfilling the definition of the term "revenue". Thus, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with AS 9. Further, in case of inter-divisional transfers, risks and rewards remain within the enterprise and also there is no consideration from the point of view of the enterprise as a whole. Thus, the recognition criteria for revenue recognition are also not fulfilled in respect of inter-divisional transfers.

In the instant case, therefore, LM Ltd cannot recognise inter-division transfers from L to M as sales and the same will have to be eliminated during finalisation. If not so done, the statutory another will have to qualify his report.

(d) Applicability of Accounting Standard: AS 20, "Earning Per Share", came into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. As such AS 20 does not mandate an enterprise, which has neither equity shares nor potential equity shares which are so listed, to calculate and disclose earnings per share, but, if that enterprise discloses earnings per share for complying with the requirements of any statute or otherwise, it should calculate and disclose earnings per share in accordance with AS 20. Part II of Schedule III to the Companies, Act, 2013, requires, among other things, disclosure of earnings per share. Accordingly, every company, which is required to give information under Part II of Schedule III to the Companies Act, 2013, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

Accordingly the company, T Pvt. Ltd should compute and disclose EPS according to AS 20. Therefore, the contention of Director (Finance) is incorrect. The auditor will have to ensure that EPS is disclosed as per AS 20 or else the auditor should appropriately modify the audit report.

Question 30

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

(a) P Pvt. Ltd. was amalgamated with PQR Ltd. with effect from 1st April, 2013. As per the scheme of amalgamation approved by the High Court, the amalgamation was to be accounted by the "Pooling of Interests Method". The scheme further provided that the

balance in Revaluation Reserve of P Pvt. Ltd. as on 31st March, 2013 was to be treated as a General Reserve on amalgamation. During the financial year 2013-14, PQR Ltd. issued bonus shares out of General Reserves (which included the amount of revaluation reserve of P Pvt. Ltd.)

(b) B Pvt. Ltd., implements a Voluntary Retirement Scheme (VRS) for its employees. It follows a policy of amortising the expenditure over 10 years. As at 1st April, 2013, the unamortised VRS expenditure was ₹ 15 lakhs. During the year 2013-14, it incurred further ₹ 12 lakhs as VRS. For the year ended 31st March, 2014, the company proposes to revise the period of amortisation to 5 years. It also proposes to follow the revised period for the opening balance.

Answer

(a) Amalgamation and Revaluation Reserve: As per AS 14, "Accounting for Amalgamations" if the amalgamation is in the nature of merger and the 'Pooling of Interest Method' is followed, the identity of the reserves is preserved and it appears in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. In the instant case, P Pvt. Ltd is amalgamated with PQR Ltd. and the amalgamation is in the nature of merger. Accordingly, Revaluation Reserves of P Pvt. Ltd. would have normally continued to remain so in PQR Ltd. However, since the scheme mentions that Revaluation Reserve is to be treated as General Reserves, the scheme will override AS 14. AS 14, "Accounting for Amalgamations", also requires that in case of any approved scheme of amalgamation if the treatment in accounting is not as per the AS, a specific disclosure of the same will have to be made alongwith the financial effect on the financial statements due to such deviation. The statutory auditor will accordingly have to ensure that the company complies with the requirements regarding treatment of reserves and other related disclosure requirements or he may be required to modify his report.

(b) Expenditure on Voluntary Retirement Scheme: AS 26, "Intangible Assets", deals with expenditure incurred on intangible items by all enterprises, except amongst others, is not applicable to expenditure in respect of termination benefits. As per the standard, termination benefits are employee benefits payable as a result of either an enterprises' decision to terminate an employee's employment before the normal retirement date; or an employee's decision to accept voluntary redundancy in exchange for those benefits (voluntary retirement). Accordingly, Voluntary Retirement Scheme (VRS) is one form of termination benefit and hence AS 26 principles are not applicable. The same has to be, therefore, accounted as per general accepted accounting practices. Accordingly, VRS expenditure would have to be written off / amortised over a reasonable period. In fact, the change of the accounting policy followed by the company to reduce the amortisation period to 5 years for the entire VRS expenditure including opening balance seems appropriate and reasonable. The auditor, however, has to examine that the requirements of AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" and impact of change in accounting policy is also disclosed as per AS 1, "Disclosure of Accounting Policies".

Question 31

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

Answer

Section 128(1) of the Companies Act, 2013 (herein after referred as the Act) requires that every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting. Further, the definition of "financial statement" in relation to a company, given under section 2(40) of the Act includes a balance sheet as at the end of the financial year; a Statement of Profit and Loss, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year; cash flow statement for the financial year (One Person company, small company and dormant company, may not include the cash flow statement); a Statement of changes in equity (if applicable); and any explanatory note annexed to, or forming part of, any of the document referred before.

Section 129(1) of the Act, requires that the financial statements shall give a true and fair view of the state of affairs of the company, comply with the accounting standards notified in this Act and shall be in the form as provided in Schedule III to this Act. It is also provided that the provisions contained in this sub-section shall not be applicable to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial; statement has been specified in or under the Act governing such class of company.

The provisions mentioned above are required to be followed by the company to maintain proper books of accounts. The Auditor is required to check that the company has complied with all the provisions related to maintenance of books of accounts etc.

Further, the books have to be maintained under accrual system and if the statutory auditor finds the books are not maintained accordingly, he will have to modify his report.

According to Section 143(3)(b), the auditor's report shall also state whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him.

If answer is in negative or with qualification, the report shall state the reasons therefor.

Question 32

A company has a branch office which recorded a turnover of ₹ 1,90,000 in the financial year 2013-14. No audit of the branch has been carried out. The statutory auditor of the company

has made no reference of the above branch in his report. The total turnover of the company is ₹ 10 crores for the year 2013-14. Comment.

Answer

As per section 143(8) of the Companies Act, 2013 if a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country.

Therefore, the company has to get its branch audited. In case no branch audit has been carried out, company's auditor is required to mention this fact in the audit report and deal appropriately.

Question 33

What are your views on the following:

(a) A Ltd. was under audit for the year ended 31.03.2014. An appeal filed by A Ltd. against the demand of Excise Duty of ₹ 26 crores was pending before the Supreme Court for which neither provision was made nor was disclosed in the notes to the financial statements. On 12th July, 2014, the auditor came to know through paper reports that the point involved in the appeal of A Ltd. was adjudicated by the Supreme Court in the case of some other assessee, which is in favour of the department of Excise Duty. The auditor insisted that provisions be made of ₹ 26 crores in the financial statements. The Management was of the view that since its own case is still pending, no provision is called for. It was also of the view that the event does not have any effect on the financial position of the company on the date of the Balance Sheet. Is the view of the Management tenable?

(b) Kevin Industries Ltd. has a paid up capital of ₹ 20 crores divided into equity shares of ₹ 10 each as on 31.03.2013. During the financial year 2013-14 it has issued bonus shares in the ratio 1 : 1. The net profit after tax for the years 31-03.2013 and 31.3.2014 is ₹ 10 crores and ₹ 15 crores respectively. The Earnings Per Share (EPS) disclosed in the financial statements for the above two years is ₹ 5.00 and ₹ 3.75 respectively. Is the disclosure correct?

(c) A firm of a father and a son is receiving ₹ 2 lakhs towards job work done for XYZ Ltd. during the year ended on 31.03.14. The total job work charges paid by XYZ Ltd. during the year are over ₹ 50 lakhs. The father is a Managing Director of XYZ Ltd. having substantial holding. The Managing Director told the auditor that since he is not involved in the activities of the firm and since the amount paid to it is insignificant; there is no need to disclose the transaction. He further contended that such a payment made in the last year was not disclosed. Is Managing Director right in his approach?

Answer

(a) Provision to be provided for in the Financial Statement: As per AS 29 "Provisions, Contingent liabilities and Contingent Assets", a contingent liability is a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

Further, 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 event will occur.

As per SA 570 "Going Concern", there are certain examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy is one of the example of such event.

When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

Since the issue involved in the appeal of A Ltd. was similar to the point in case of some other company and since the appeal of that company was decided against that company and in favour of the Excise Department, it is necessary for A Ltd. to make a provision of ₹ 26 crores as per AS 29. The case settled by the Supreme Court on similar point reflects significant developments affecting the assessment about the potential risk faced by the company. The view of the management that its own appeal is undecided or that it has no effect on the financial position as on 31.03.2014 is not at all tenable. Since the financial position is materially affected, the auditor should express a qualified opinion or an adverse opinion as may be appropriate.

(b) Disclosure of Earnings Per Share: AS 20 on Earning Per Share (EPS) prescribes principles for the determination and presentation of EPS. As per AS 20, the earnings per share have to be disclosed as basic and diluted earnings per share on the face of the Statement of Profit and Loss for each class of equity shares that has a different right to share in the net profit for the period. In the instant case, Kevin Industries Ltd., both the basic as well as the diluted earnings per share would be the same since there are no dilutive instruments that have been issued by the company. As per AS 20, in the case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration and thus would lead to increase in number of equity shares without any adjustment to outstanding capital amount. Therefore, the number of equity shares

outstanding is increased without an increase in resources. The standard further requires that the number of equity shares outstanding before the event of a bonus issue to be adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. Hence the EPS calculated as on 31-03-2003 would be Adjusted EPS and the same would be disclosed. In view of the above, the EPS will be calculated as under:

As on 31.03.2013	$\frac{\text{Profits}}{\text{Adjusted No. of Shares}}$	=	Adjusted EPS
	$\frac{10,00,00,000}{4,00,00,000}$	=	₹ 2.5
As on 31.03.2014	$\frac{\text{Profits}}{\text{No. of shares}}$	=	EPS
	$\frac{15,00,00,000}{4,00,00,000}$	=	₹ 3.75

Since the above figures of EPS have not been disclosed, Kevin Industries Ltd. has not complied with the provisions of AS 20. ***Therefore, the auditor would have to qualify his report in terms of section 143(3)(e) of the Companies Act, 2013.***

(c) Related Party Disclosures: As per definition given in the AS 18 " Related Party Disclosures" parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

In the instant case, the managing director of XYZ Ltd. is a partner in the firm with his son which has been paid ₹ 2 lakhs as job work charges. The managing director is having a substantial holding in XYZ Ltd. The case is squarely covered by AS 18. According to AS-18, in the case of related party transactions, the reporting enterprise should disclose the following:

(i) the name of the transacting related party;

(ii) a description of the relationship between the parties;

(iii) a description of the nature of transactions;

(iv) volume of the transactions either as an amount or as an appropriate proportion;

(v) any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and

(vii) amounts written off or written back in the period in respect of debts due from or to related parties."

Further, SA 550 on "Related Parties", also prescribes the auditor's responsibilities and audit procedures regarding related party transactions.

The approach of the managing director is not tenable under the law and accordingly all disclosure requirements have to be complied with in accordance with the AS 18. Auditor should insist to make proper disclosure as per the AS and if management refuses, the auditor shall have to modify his report. Also it has to be seen whether section 184 of the Companies Act, 2013 regarding disclosure of interest by director has been complied with. If it is not complied with, the auditor needs to modify the report appropriately.

Question 34

Do you approve of the following? If not, why?

(a) Trimurthy Pan Masala (P) Ltd. was incurring heavy losses in the last several years since it could not withstand the competition in the market. The State in which the company had its registered office and also its major sales had moved a bill in the State Assembly to ban manufacture and sale of all kinds of Pan Masalas in the State. While finalizing the accounts for the year ended 31-03-2014, the CFO of the company created a Deferred Tax Asset for the tax benefits that would arise in future years from the earlier years losses that had remained unabsorbed in Income Tax.

(b) Big Ltd. has borrowed ₹ 30 lakhs from State Bank of India during the financial year 2013-14. The borrowings are used to invest in shares of Small Ltd., a subsidiary company of Big Ltd., which is implementing a new project estimated to cost ₹ 50 lakhs. As on 31st March, 2014, since the said project was not complete, the directors of Big Ltd. resolved to capitalize the interest accruing on borrowings amounting to ₹ 4 lakhs and add it to the cost of investments.

Answer

(a) Creation of Deferred Tax Asset: Accounting Standard 22 on "Accounting for Taxes" requires that Deferred Tax Asset (DTA) should be recognised for all timing differences, subject to the considerations of prudence. The Standard further states that unabsorbed losses of the business can be considered for creation of DTA provided there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such DTA can be realised. In view of this, the DTA created by the CFO of Trimurthy Pan Masala (P) Ltd. is not in order. Since the company which is in the business of manufacturing of *panmasala* has been incurring heavy losses and in addition to this the State in which the company is having its major sales is proposing the ban on sale and manufacture of pan masala, the statutory auditor would, therefore, have to qualify his report and mention the extent of amounts of loss and reserves which are under and overstated respectively.

(b) Capitalisation of Interest: As per AS 13 on "Accounting for Investments", the cost of investment includes acquisition charges such as brokerage, fees and duties. In the instant case, Big Ltd. has used borrowed funds for purchasing shares of its subsidiary company Small Ltd. ₹ 4 lakhs interest payable by Big Ltd. to State Bank of India can not be called as cost of investment. The Accounting Standard 16 on "Borrowing Costs" also does not consider investment in shares as qualifying asset that can enable a company to add the borrowing costs to investments. In the instant case, the statutory auditor would qualify his report by stating that the borrowing costs have been wrongly added to the cost of investments rather than charging them to Statement of Profit and Loss. The effect of the same on the profits for the year would also have to be mentioned.

Question 35

Miranda Spinning Mills Ltd. is a sick company and has accumulated losses of ₹ 10 crores. The company has ₹ 12 crores in its share Premium Account. The Management desires to adjust the accumulated losses against the share premium balance. Advise the company giving your reasons.

Answer

Application of Share Premium Account: Section 52 of the Companies Act, 2013 (herein after referred as the Act) deals with the application of premium received on issue of shares. 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 of the premium received on those shares shall be transferred to an account called "Securities Premium Account" and the provisions of this Act relating to reduction of share capital of a company except as provided in this section shall apply as if the securities premium account was the paid up share capital of the company. Sub-section (2) of the said section provides that notwithstanding anything contained in sub-section (1), securities premium account may be applied by the company for issue of bonus shares; writing off the preliminary expenses; writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; in providing for the premium payable on redemption of any redeemable preference shares or any debentures of the company; for the purchase of its own shares or other securities. In view of these provisions of the Companies Act, 2013, it is not permitted to adjust its accumulated losses against the securities premium account.

Question 36

Write short notes on Responsibility of Joint Auditors.

Answer

Responsibility of Joint Auditors: SA 299 on, "Responsibility of Joint Auditors" deals with the professional responsibilities which the auditors undertake in accepting such appointments as joint auditors. The responsibilities of joint auditors, as a rule are no different from the responsibilities of individual auditors as enumerated in the Companies Act. Main features of the said SA are discussed below:

(i) Division of Work: Where joint auditors are appointed, they should, by mutual discussion, divide the audit of identifiable units or specified areas. Certain areas of work, owing to their importance or owing to the nature of work involved would not be divided and would be covered by all the joint auditors. Such a division affected by the joint auditors should be adequately documented and preferably communicated to the auditee.

(ii) Coordination: Where in the course of his work, a joint auditor comes across matters which are relevant to the areas of other joint auditors and which require joint discussion, he should communicate the same to all the other joint auditors in writing before the finalisation of audit and preparation of audit report.

In respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

(i) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(ii) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.

(iii) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(iv) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(v) for ensuring that the audit report complies with the requirements of the relevant statute.

(vi) It is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit.

(vii) The responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors.

(viii) Each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

Normally, the joint auditors are able to arrive at an agreed report. However where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

Question 37

In the books of accounts of M/s OPQ Ltd. huge differences are noticed between the control accounts and subsidiary records. The Chief Accountant informs that this is common due to

huge volume of business done by the company during the year. As a Statutory Auditor, how would you deal?

Answer

Difference between Control Accounts and Subsidiary Records: The huge differences found between control accounts and subsidiary records in the books of M/s OPQ Ltd. indicate that there may be material misstatements requiring detailed examination by the auditor to ascertain the cause. The contention of Chief Accountant cannot be accepted simply because the company has done huge volume of business. Such a phenomenon indicates that recording of transactions is not being done properly or the accounting system in the company which might have several branches spread over the country fails to capture all transactions in time. It would also be interesting to see whether it is a recurring phenomenon or such reconciliation could not be done at a subsequent date. Having regard to all these circumstances, it appears from the facts of the case that these differences indicate the possibility of some kind of material misstatements. As per SA 240, "The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements", 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. When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit.

6

The Company Audit

Question 1

X Limited, a newly incorporated company in India commenced its business from April 1, 2012. The Company purchased fixed assets costing ₹ 4,000 lakhs on 01-04-2012 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal installments. Exchange rates were 1 Dollar = ₹ 40.00 and ₹ 42.50 as on 01-04-2012 and 31-03-2013 respectively. The company worked out foreign exchange loss as per AS 11 at ₹ 250 Lakhs and expensed the entire amount in the profit and loss account. The Managing Director of the company was worried about this heavy revenue loss and asked the accountant not to follow AS 11 issued by the ICAI for this particular transaction. The Accountant of the company, followed the instruction of the Managing Director and removed exchange loss from the profit and loss account but then he added the entire exchange loss to the value of fixed asset and computed the depreciation thereon. As an Auditor of X Limited how you would deal with this particular transaction? (5 Marks, November, 2013)

Answer

Treatment of Changes in Foreign Exchange Rates: As per Para 46A(1) of AS 11 "The Effects of Changes in Foreign Exchange Rates'' inserted by Ministry of Corporate Affairs by way of notification, the exchange differences arising on reporting of long- term foreign currency monetary items in so far as they relate to the acquisition of a depreciable capital asset, in respect of accounting periods commencing on or after the 1st April, 2011, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, it can be accumulated in a ''Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long term asset or liability, by recognition as income or expense in each of such periods.

Thus, X Ltd. has the choice to avail this option. However, the company should disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized.

Question 2

Excellent Limited, a Company incorporated in India and listed with SEBI, has a scheme for payment of settlement allowance to retiring employees. Under the scheme, retiring employees are entitled to reimbursement of certain travel expenses for class they are entitled to as per company ~les and regulations. Employees are also entitled to claim a lump-sum payment to cover expenses on food and stay during the travel. The Company also gives option to employees that they can claim a lump-sum amount equal to three months pay last drawn.

Excellent Limited have following accounting policies to record these travel expenses:

(i) Settlement allowance does not depend upon the length of service of employee. It is restricted to employee's eligibility under the travel rule of the company therefore all travel expenses fall under the category of defined contribution plans.

(ii) Since it is not related to the length of service of the employees, it is difficult to estimate reliably and there is no present obligation to pay employees as per AS 29 "Provisions, Contingent Liabilities and Contingent Assets", hence it is accounted for on claim basis.

You are statutory auditor of Excellent Limited. What would be your guidance to audit team?

(4 Marks, November, 2013)

Answer

Treatment of Employee Benefits Expenses: The present case falls under the category of defined benefit scheme under AS 15 "Employee Benefits". The said scheme encompasses cases where payment promised to be made to an employee at or near retirement presents significant difficulties in the determination of periodic charge to the statement of profit and loss. The contention of the Company that the settlement allowance will be accounted for on claim basis is not correct even if company's obligation under the scheme is uncertain and requires estimation. In estimating the obligation, assumptions may need to be made regarding future conditions and events, which are largely outside the company's control. Thus,

(i) Settlement allowance payable by the company is a defined retirement benefit, covered by AS 15.

(ii) A provision should be made every year in the accounts for the accruing liability on account of settlement allowance. The amount of provision should be calculated according to actuarial valuation.

(iii) Where, however, the amount of provision so determined is not material, the company can follow some other method of accounting for settlement allowances.

Question 3

X Ltd is engaged in the business of newspaper and radio broadcasting. It operates through different brand names. During FY 12-13 it incurred substantial amounts on external trade, business communication and branding expenses by participation in various corporate social responsibility initiatives. The company expects to benefits by this expenditure by attracting new customers over a period of time and accordingly it has capitalized the same under brand development expenses and intends to amortize the same over the period in which it expects the benefits to flow. As the statutory auditor of the company do you concur? Give reasons.

(4 Marks, November, 2013)

Answer

As per **AS-26 on "Intangible Assets"**, expenditure on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria.

In the given case, it incurred substantial amounts on external trade, business communication and branding expenses by participation in various corporate social responsibility initiatives. The company expects to benefits by this expenditure by attracting new customers over a period of time and accordingly it has capitalized the same under brand development expenses. Here, no intangible assets or other asset is acquired or created that can be recognized.

Therefore the accounting treatment by the company to amortize the entire expenditure over the period in which it expects the benefits to flow is not correct and the same should be debited to the Statement of Profit and Loss in the year of incurring.

Question 4

(a) The Balance Sheet of G Ltd as at 31st March 13 is as under. Comment on the presentation in terms of revised Schedule VI and Accounting Standards issued by NACAS.

Heading	*Note No.*	*31st March, 13*	*31st March, 12*
Equity & Liabilities			
	1	*XXX*	*XXX*
	2	*0*	*0*
	3	*XXX*	*XXX*
	4	*XXX*	*XXX*
Non-Current Liabilities		*XXX*	*XXX*
Deferred tax liability (Arising from Indian Income Tax)	*5*	*XXX*	*XXX*
Current Liabilities			
Trade Payables	*6*	*XXX*	*XXX*
Total		*XXXX*	*XXXX*
Assets			
Non-Current Assets			
Fixed Assets-Tangible	*7*	*XXX*	*XXX*
CWIP (including capital advances)	*8*	*XXX*	*XXX*
Current Assets			
Trade Receivables	*9*	*XXX*	*XXX*
Deferred Tax Asset (Arising from Indian Income Tax)	*10*	*XXX*	*XXX*
P & I Debit balance		*XXX*	*XXX*
Total		*XXXX*	*XXXX*

(b) Z Ltd changed its employee remuneration policy from 1st of April 2012 to S provide for 12% contribution to provident fund on leave encashment also. As per the leave encashment policy the employees can either utilize or encash it. As at 31st March 13 the company obtained an actuarial valuation for leave encashment liability. However it did not provide for 12% PF contribution on it. The auditor of the company wants it to be provided but the management replied that as and when the employees availed leave encashment, the provident fund contribution was made. The company further contends that this is the correct treatment as it is not sure whether the employees will avail leave encashment or utilize it. Comment.

(c) T. Ltd. commenced its manufacturing activities from 1st April, 2012. In the course of production the company generated certain by-products. As at 31st March 13 the company did not value the by-products considering the value as insignificant. The auditor of the company is of the opinion that the by-products are inventory of the company and it should be valued and brought into books of account. Comment.

(d) K Ltd. had 5 subsidiaries as at 31st March 2013 and the investments in-subsidiaries are considered as long term and valued at cost. Two of the subsidiaries net worth eroded as at 31st March 13 and the prospects of their recovery are very bleak and the other three subsidiaries are doing exceptionally well. The company did not provide for the decline in the value of investments in two subsidiaries because the overall investment portfolio in subsidiaries did not suffer any decline' as the other three subsidiaries are doing exceptionally well. Comment. (5 Marks each, May, 2013)

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) As per Para 11 of **AS-15 on "Employee Benefits"**, issued by the Institute of Chartered Accountants of India, an enterprise should recognize the expected cost of short-term employee benefits in the form of compensated absences in the case of accumulating compensated absences, when the employees render service that increases their entitlement to future compensated absences.

Since the company obtained actuarial valuation for leave encashment, it is obvious that the compensated absences are accumulating in nature. An enterprise should measure the expected cost of accumulating compensated absences as the additional amount that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date.

Here, Z Ltd will accumulate the amount of leave encashment benefits as it is the liability of the company to provide 12% PF on amount of leave encashment. Hence the contention of the auditor is correct that full provision should be provided by the company.

(c) As per **AS-2 on "Valuation of Inventories"**, issued by the Institute of Chartered Accountants of India, a production process may result in more than one product being produced simultaneously. This is the case when joint products are produced or when there is a main product & by-products. If the costs of conversion of each product are not separable, they are allocated on a rational & consistent basis.

Most of the by-products as well as scrap or waste materials, by their nature, are immaterial. They are often measured at net realizable value & this value is deducted from the cost of the main product. In the given case, as the value of the by-products is insignificant, the realizable value of by products should be ascertained and it should be deducted from the cost of the main product.

An asset is a resource controlled by an enterprise as a result of past events from which the future economic benefits are expected. As per AS 2, inventories are assets (a) held for sale in the ordinary course of business (b) in the process of production for such sale (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services. As the stock of by-product is a resource controlled by T Ltd., it is an asset and it is inventory because it is held for sale in the ordinary course of business.

Hence, T Ltd. should deduct the realizable value of its by products from the cost of production of main product.

(d) As per **AS-13 "Accounting for Investments"** issued by the Institute of Chartered Accountants of India, long-term investments are usually of individual importance to the investing enterprise. The carrying amount of long-term investments is therefore determined on an individual investment basis. Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognize a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

Keeping in view the above, K Ltd should provide for the decline in the value of investments in two subsidiaries despite the fact that the overall investment portfolio in subsidiaries did not suffer any decline.

Question 5

As a statutory auditor of a company, comment on the following:

(a) For the year ended 31st March, 2012, the financial statements of A Pvt. Ltd. were adopted on 31st July, 2012. At this meeting, the directors proposed a dividend for the year 2011-12 of 25% on the equity share capital amounting to ₹ 10 lakhs. No entry was passed for the proposed dividend in the books of the company, since in the view of the directors the same was not required as per Revised Schedule VI.

(b) The accounting policy on Revenue Recognition for a company engaged in manufacture and sale of chemical products was stated as "Revenue is recognized only when it can be reliably measured and it is reasonable to expect ultimate collection".

(5 Marks each, November, 2012)

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) **Revenue Recognition**: As per AS 9 Revenue Recognition, in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) 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

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

Therefore, revenue from sales transactions should be recognised when the requirements as to performance set out above is satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim uncertainty regarding collection exist, then revenue recognition should be postponed.

In the instant case, the company is engaged in manufacturing and sale of chemical products, and made disclosure in accounting policy on recognition of revenue as per AS 1 stating that revenue is recognized only when it can be reliably measured and it is reasonable to expect ultimate collection, is correct. However, accounting policy disclosed above should also cover the aspect of transfer of risk and reward for the purpose of revenue recognition.

Question 6

Comment "M/s. PQR has been appointed the sole statutory auditor of a large company for 2011-12, where till last year M/s. LMN was also one of the joint auditors along with M/s. PQR. Mention the steps that should be taken by M/s. PQR before commencing the audit".

(8 Marks, November, 2012)

Answer

Steps before Commencing the Audit Work: When one of the joint auditors of the previous year is considered for ratification by the members as the sole auditor for the next year, it is similar to non re-appointment of one of the retiring joint auditors. The provisions of section 140 of the Companies Act, 2013 (hereinafter referred as the Act) relating to non-reappointment of the retiring auditor need to be considered. As per sub-section 4 of section 140 of the Act, special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or, as the case may be, ten years, as provided under sub-section (2) of section 139 of the Act.

The following steps should be taken care of by M/s. PQR before commencing the audit:

(i) Ascertain that special notice under Section 140(2) of the Act was duly received by the company, from such number of members holding not less than one percent of total voting power or holding shares on which an aggregate sum of not less than five lakh rupees has been paid up on the date of the notice, not earlier than three months but at least 14 days before the AGM date as per Section 115 of the Act read with rule 23(1) and 23(2) of the Companies (Management and Administration) Rules, 2014.

(ii) Check whether the said notice has been sent to all the members at least 7 days before the date of the AGM as per Section 115 of the Act read with rule 23(3) of the Companies (Management and Administration) Rules, 2014.

(iii) Verify the notice contains an express intention of a member for proposing the resolution for appointing a sole auditor in place of both the joint auditors who retire at the meeting but are eligible for re-appointment.

(iv) Verify that the said notice is also sent to the retiring auditor as per Section 140(4)(ii) of the Act.

(v) Verify whether any representation received from the retiring auditor was sent to the members of the company to whom notice of the meeting was sent as per Section 140(4)(iii) of the Act.

(vi) Verify from the minutes book whether the representation received from the retiring joint auditor was considered at the AGM.

(vii) Examine that proposed resolution was properly passed.

Further, Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts a position as auditor previously held by another chartered accountant without first communicating with him in writing. Moreover, Clause (9) of Part I of the same Schedule, 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 (now Section 139 and 140 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

Therefore, M/s PQR is required to comply with all the above mentioned provisions provided under Companies Act and Chartered Accountant Act before commencing the audit.

Question 7

A Ltd is a manufacturer of readymade garments. It sells its products to franchisees located across the country. Readymade garment industry is subject to change in trends of fashion and as such, some of the goods are returned and A Ltd accepts them back as sales returns. On the basis of past trends such returns are estimated to be at 20% of the sales of any year. For the financial year 2011-12, A Ltd had accounted for the actual sales return made upto 31st March 2012 but has not reversed the possible expected return that are likely to happen after 31st March 2012, in respect of the sale made for the FY 11-12. Mr. X the auditor of A Ltd wants this to be considered in the accounts for the year ended on 31st March 2012 but the company is of the opinion that although there is a probability of some goods being returned by the franchisees, there is no significant uncertainty regarding the amount of consideration that will be derived from the sale of goods, since the goods are not in the possession of the company and risk and rewards of ownership still lie with the franchisees and the company cannot record sales returns in its books of account in respect of goods that are likely to be received after the date of balance sheet. Comment. (5 Marks, May, 2012)

Answer

Recognition of Revenue: AS 9 on 'Revenue Recognition', states that revenue from sale of goods should be recognised when the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership and no significant uncertainty exists regarding the amount of consideration.

Further, revenue recognition is mainly concerned with the timing of recognition of revenue in statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by the agreement between the parties involved in the transaction. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

In the present case, A Ltd. is a manufacturer of readymade garments and sells its products to franchisees located across the country. Due to change in trends of fashion etc sold goods are being returned and A Ltd. accepts them back as sales returns. On the basis of past trends such returns are estimated as 20% of the sales of any year.

In this case, the company is bearing the risk of sales return and therefore, the company should not recognize the revenue to the extent of 20% of its sales. The company may disclose suitable revenue recognition policy in its financial statements separately.

In the absence of the above, the auditor must qualify his report.

Note: Alternative Answer is possible on the basis of AS 29 on Provisions, Contingent Liabilities and Contingent Assets by recognising the whole sales as revenue, i.e., 100% accounted in Statement of Profit and Loss as sales Income as there is no significant uncertainty regarding the amount of consideration. However, keeping in view its past performance, A Ltd. should 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.

Question 8

Comment on the following:

(a) MRE Ltd. provided ₹ 25 lakhs for Inventory obsolence in 2009-10. In the subsequent years, it was determined that 50% of such stock was usable. The Board of Directors wants to adjust the same through prior period adjustment. (5 Marks, November, 2011)

(b) SRS Ltd. has drawn the financial statement as on 31-3-11 and presented to you alongwith additional information:

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

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

Additional Information:

(a) Entire pre-operative expenses of ₹ 7,00,000/- was charged to Profit and Loss Account whereas for the purpose of Income Tax, only what is allowable is claimed.

(b) Depreciation as per Books - ₹ 35,00,000/-

Depreciation as per Income tax - ₹ 50,00,000/-

(c) Losses to be carried forward as per Income Tax Act - ₹ 16,00,000/-

(d) Donation disallowed while computing tax - ₹ 50,000/-

Considering the additional information, can you certify that the company has complied with the Accounting Standards and issue an unqualified report? (6 Marks, November, 2011)

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

Answer

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

An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

A change in an accounting estimate may affect the current period only or both the current period and future periods. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Question 9

A infrastructure company has constructed a mall and entered into agreement with tenants towards license fees (monthly rental) and variable license fees, a percentage on the turnover of the tenant (on an annual basis). Chief Finance Officer wants to account/recognize license fee as income for 12 months during current year under audit and variable license fees as income during next year, since invoice is raised in the subsequent year. As an auditor, how would you deal and state in the statement of Accounting policies? (6 Marks, November, 2011)

Answer

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 Statement of Profit and Loss does not exhibit a true and fair view of the profit or loss.

Question 10

(a) In the course of audit of T Ltd. you observed that export incentives are not accounted on accrual basis. The company's management contended that these would be accounted on cash basis citing the uncertainty about its receipts as they are not admitted as due by the customs authorities. Comment. (4 Marks, May, 2011)

(b) Z Ltd. has flexi deposit linked current account with various banks. Cheques are issued from the current account and as per the requirements of funds, the flexi deposits are encashed and transferred to current accounts. As of 31st March, 2011 certain cheques issued to vendors are not presented for payment resulting in the credit balance in the books of the company. The management wants to present the book overdraft under current liabilities and flexi deposits under cash & bank balances. Comment.

(8 Marks, May, 2011)

Answer

(a) 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 T 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 does 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 T Ltd. has to account the export incentives on Accrual basis.

(b) Presentation of Book Overdraft as per Schedule III to the Companies Act, 2013: The instructions in accordance with which current assets being "cash and cash equivalents" should be made out to Part I of Schedule III to the Companies Act, 2013 states as follows:

(i) Cash and cash equivalents shall be classified as:

  (a) Balances with banks;

  (b) Cheques, drafts on hand;

  (c) Cash on hand;

  (d) Others (specify nature).

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months maturity shall be disclosed separately.

From the facts of the case it is evident that in substance the position is that the composite bank balance including the balance in flexi deposit accounts are positive, even though physical set-off has not been made as on the balance sheet date. Further the bank has got the right to set off of flexi deposits against the cheques issued and hence it would be more informative and useful to the readers of the financial statements to disclose the book credit balance as a set-off from the flexi deposit accounts. The disclosure of the said book credit balance as book overdraft under the head current liabilities as proposed by the management is not correct.

Question 11

Comment on the following:

(a) B Co. Ltd. is engaged in the business of developing mass scale housing projects including development of small commercial complexes. The flats/commercial spaces are booked by the public and are allotted by way of allotments letter to each allottee. Major construction activities pertaining to buildings are undertaken after allotment is over. After completing the construction, possession of flats/commercial spaces is given to allottees by executing legal document. The CEO of the B Co. Ltd. says that AS 7 is not applicable to the company.

(b) In the notes to accounts of C Co. Ltd. as on 31-03-2010 Note no. 11 states that 'Certain machinery items are lying at customs warehouses and company has paid ₹ 900 lakhs up to 30-06-2009 as detention charges, out of which a sum of ₹ 580 lakhs is written back during the year 2009-10 based on settlement with the concerned authorities in respect of a major spares of machinery. For the remaining machinery items negotiations are pending and a provision of ₹ 44 lakhs is made. As such total amount of ₹ 364 lakhs paid/provided on account of detention charges have been capitalized and included in the Fixed Assets/Capital work in progress. The management is of the view that these expenses are directly attributable to the acquisition of the related Fixed Asset.

(c) During the course of audit of D Co. Ltd. you as an auditor have observed that Inter Corporate deposit of ₹ 50 lakhs has been overdue. The D Co. Ltd. have disclosed this in the notes to accounts note No. 15 in schedule no. 21 stating that ₹ 50 lakhs is overdue from XYZ Co. Ltd. and the said company is in the process of liquidation. The management is taking steps to appoint the liquidator. (5 Marks each, November, 2010)

Answer

(a) Applicability of AS 7: 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".

(b) Accounting for Fixed Assets lying at Custom Warehouses: 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 Statement of Profit and Loss 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 Statement of Profit and Loss. 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."

(c) 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.

Question 12

Mr. Ram, a relative of a Director was appointed as an auditor of the company. Comment.

(6 Marks, November, 2010)

Answer

Appointment of the Auditor: Section 141 of the Companies Act 2013 (herein after referred as the Act) deals with the eligibility, qualifications and disqualifications of Auditors. Sub-section (3)(f) of the Section 141 of the Act, explicitly disqualifies a person from being appointed as an auditor of a company whose relative is a director or is in the employment of the company as a director or key managerial personnel.

According to the Code of Ethics there is no direct restriction on a member to accept the audit of a company where his relative is director. Further, as per Clause 4 of Part 1 of the Second Schedule to the Chartered Accountants Act, 1949 there is professional misconduct if the member expresses his opinion on financial statements of any business or enterprise in which he, his firm or a partner in his firm has a substantial interest. Here also there is no mention of relative. But this clause has been inserted for the purpose of ensuring the independence of the auditor so that his opinion on the financial statements is an independent opinion free of any interest.

In August 2008, the council has issued a guideline in this respect. As per that guideline a member of the institute shall desist from expressing his opinion on financial statements of any business or enterprise in which one or more persons, who are relatives within the meaning of section 6 of the Companies Act, 1956 (now Section 2(77) of the Companies Act, 2013), have either by way of themselves or in conjunction with such members, a substantial interest in the said business or enterprise. Therefore if the director has substantial interest in the company then his relative should not accept the appointment of auditor of that company.

In the instant case, Mr. Ram is the relative of a Director of the Company, therefore he should not accept the appointment as an auditor of that company.

Question 13

While doing the audit, X, the Statutory Auditor of ABC Ltd. observes that certain loans and advances were made without proper securities, certain debtors and creditors were adjusted inter se, and personal expenses were charged to revenue. Comment. (6 Marks, November, 2010)

Answer

Audit Report: Section 143(1) of the Companies Act, 2013 requires the auditor to make an enquiry in respect of specified matters during the course of his audit. Since the law requires the auditor to make an enquiry, the Institute opined that the auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. It is to be noted that the auditor is required to make only enquiries and not investigate into the matters referred to therein.

Clause (a) of Section 143(1) requires the auditor to inquire: "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 prejudicial to the interests of the company or its members".

If the auditor finds that the loans and advances have not been properly secured, he may enter an adverse comment in the report but cannot probably doubt the true view of the accounts by reference to this fact so long the loans and advances are properly described and presented in terms of Part I of Schedule III to the Companies Act. Further the auditor to inquire whether or not the terms on which the loans or advances have been made are prejudicial to the interests of the company or its members. If it is, he should qualify his report.

If debtors and creditors are adjusted inter se, this amounts to merely book entries. The auditor, as per clause (b) of section 143(1), should enquire "whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company". This proposition has got to be inquired into by reference to the effects of the book entries, unsupported by transactions, on the legitimate interests of the company. The auditor has to exercise his judgment based on certain objective standards".

Regarding Personal Expenses, Clause (e) of section 143(1) requires the auditor to inquire: "Whether personal expenses have been charged to revenue account". The charging to revenue of such personal expenses, either on the basis of the company's contractual obligations, or in accordance with accepted business practice, is perfectly normal and legitimate or does not call for any special comment by the auditor. Where, however, personal expenses not covered by contractual obligations or by accepted business practice are incurred by the company and charged to revenue account, it would be the duty of the auditor to report thereon. It suffices to say that if the auditor finds that personal expenses have been charged to revenue and if the amounts are material, he should qualify his report also.

In the instant case, Mr. X, the statutory auditor of ABC Ltd., needs to enquire in light of above provisions, as a result of the enquiries if he is satisfied then there is no further duty to report on these matters.

Question 14

Comment on the following:

(a) T Ltd. an Indian company, subject to Indian Income tax Act, 1961, discloses advance Income-tax paid (Current tax asset) and provision for Income-tax (Current tax liability), separately in Balance Sheet for the year ended 31.3.2010, i.e., it does not offset the amount.

(b) F Limited includes in the Schedule of Inventory, those items of Fixed assets which have not been in active use and held for disposal, as inventory item.(5 Marks each, May, 2010)

Answer

(a) Offsetting Assets and liabilities: As per paragraph 27 of Accounting Standard (AS) 22– "Accounting for Taxes on Income", an enterprise should offset assets and liabilities representing current tax if the enterprise:

(i) has a legally enforceable right to set off the recognized amounts and

(ii) intends to settle the asset and liability on a net basis.

An enterprise will normally have a legally enforceable right to set off an asset and liability representing current tax when they relate to income taxes levied under the same governing taxation laws and the taxation laws permit the enterprise to make or receive a single net payment.

Since T Ltd is an Indian Company, and as per Income Tax Act, 1961, such set off is allowed which is legally enforceable. Thus, in view of Provisions of AS 22 and Income Tax Laws, T Ltd. should offset advance tax paid against provision for income tax and show only the net amount in the balance sheet.

(b) Accounting for Fixed Assets held for disposal: 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, F 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.

Question 15

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. Comment. (5 Marks, November, 2009)

Or

Dark Ltd. has received a grant of ₹ 20 lacs under the Government's Subsidy Scheme for acquiring an imported machinery for setting up an oil exploration plant and the entire grant received is credited to Profit and Loss account. (4 Marks, November, 2006)

Answer

Accounting for Government Grants: 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 Statement of Profit and Loss 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 Statement of Profit and Loss on a systematic and rational basis over the useful life of the asset. By crediting the entire amount of grant to the Statement of Profit and Loss, 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.

Question 16

What do you understand about Reserved Capital as provided under Section 99 of the Companies Act, 1956? How is it different from Capital Reserve? (4 Marks, November, 2009)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 17

What are the duties of a statutory auditor regarding disqualification of a director u/s 274(1)(g) of the Companies Act, 1956 ? (8 Marks, June, 2009)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 18

X Ltd. did not follow the applicable Accounting Standard for disclosing Earnings Per Share (EPS) in the financial statements. The fact of such non-disclosure was however, mentioned in the notes forming part of accounts. As the statutory auditor of X Ltd., how would you report in the above case? (5 Marks, June, 2009)

Answer

Disclosure of EPS is required for all companies as per AS 20 "Earnings per Share". AS 20 is also one of the AS notified by Section 133 of the Companies Act, 2013 read with the clarification given by the Ministry of Corporate Affairs (MCA) vide General Circular that the existing Accounting Standards notified under the Companies Act, 1956 shall continue to apply till it is prescribed by Central Government.

If the disclosures required by AS 20 are not made, it is the duty of the auditor to qualify in his report "Whether Accounting Standards under the clause as notified u/s 129(1) have been followed?" Mere disclosure by company in notes does not absolve him of his duty.

The same is, however, not a qualification to affect the "True & Fair" position of financial results of the company.

Question 19

Comment on the following:

(a) X Ltd., paid ₹ 25 lakhs as advance to Y Ltd. towards the purchase of a printing machinery on 15.1.08 with delivery instructions to deliver the same in the last week of June, 08. Further on 2.2.08 X Ltd. purchased two diesel generator sets from Y Ltd. for ₹ 30 lakhs on 90 days Credit term. In the accounts for 2007-08, X Ltd. intends to adjust the advance paid against Credit purchase and show the net amount of ₹ 5 lakhs as due from them. As the statutory auditor, how would you deal with this?

(b) The Statutory auditors of Getwell Ltd. included certain comments in his report u/s 227 of the Companies Act, 1956. Since the company requested the auditors to drop the above comments, as otherwise it will affect their future business, as a compromise the auditor included the comment in the report in ordinary type. (5 Marks each, November, 2008)

Answer

(a) Adjustment of Advances: Since X Ltd. has paid advance amount to the supplier of machinery to be used in the project, such advance amount should be grouped under the head 'Capital Work in Progress'. This is as per requirement of Schedule III to the Companies Act, 2013 and the existing accounting practice.

If the advance is for purchase of other machinery, it should be grouped under a separate head – say 'Advance Payment for Capital Expenditure' and should be disclosed as next item to Fixed Assets in the Balance Sheet.

In view of the above, the proposal of X Ltd., to show the net balance in the personal account of Y Ltd., is not correct. Such proposal will conceal the two material items in the balance sheet – one, expenditure towards capital asset and the other current liability for purchase of the generator set.

Hence, the auditor should advise X Ltd. to show these two items separately. If X Ltd. does not accept the advice, the auditor should qualify his report with suitable quantification of amount involved.

(b) This question is redundant in view of the provisions of the Companies Act, 2013.

Question 20

As Auditor of Act Fast Ltd. what steps will you take to ensure that the dividend has been paid only out of profit? (8 Marks, November, 2008)

Answer

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

1. Check whether the dividend was declared out of profits arrived at after providing for depreciation as per Section 123(2) of the Companies Act, 2013 (herein after referred as the Act).
2. Check whether-
   - (i) the depreciation was provided according to provision of Schedule II to the Act.
   - (ii) a board resolution recommending dividend was passed.
   - (iii) the dividend was declared only in the Annual General Meeting.
   - (iv) no dividend declared in general meeting exceeds the amount recommended by the Board.
   - (v) amount paid or credited as paid on a share in advance of calls is not treated for the purpose of this regulation as paid on the share.
   - (vi) register of members was closed as per the provisions of section 91 of the Act.
   - (vii) dividend has been paid in the prescribed manner within 30 days of time to the registered holder or their order for the compliance of Section 127 of the Act.
   - (viii) Amount of dividend deposited in a separate bank account within five days from the date of declaration of dividend.
   - (ix) intimation sent to Stock Exchange in the case of listed company.

(x) were there any complaints of non-payment/delayed payment of dividend? If so, whether corrective action was taken.

Question 21

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

(a) While adopting the accounts for the year, the Board of Directors of Sunrise Ltd. decided to consider the Interim Dividend declared @15% as final dividend and did not consider transfer of Profit to reserves. (4 Marks, May, 2008)

(b) V Ltd. sold 1 lakh vacuum pumps during the year 2006-07 with a condition to make good by repair/replacement any manufacturing defects reported within 6 months from the date of sale. Past experience in this regard showed that there were no replacements carried out, but minor/major repairs were necessitated to the extent of 10%/5% respectively of the units sold. The cost of such minor/major repairs would amount to ₹ 1,000/₹ 6,000 respectively. While finalizing the accounts for the year, the company does not reflect any provision, in this regard. (5 Marks, May, 2008)

(c) XYZ Pvt. Ltd., manufacturing garments, has valued at the year end its closing stock of packed finished goods for which firm export contracts have been received, at realizable value inclusive of profit and export cash incentive. As at the year end, the ownership of the goods has not been transferred to the foreign buyers. (4 Marks, May, 2008)

Answer

(a) Declaration of Interim Dividend: Section 123(3) of the Companies Act, 2013 provides that the Board of Directors of a company may declare interim dividend during any financial year out of the surplus in the profit and loss account and out of profits of the financial year in which such interim dividend is sought to be declared. The amount of dividend including interim dividend should be deposited in a separate bank account within five days from the declaration of such dividend for the compliance of Section 123(4) of the said Act.

Based on Section 2(35) of the said Act, it can be said that since interim dividend is also a dividend, companies should provide for depreciation as required by Section 123 before declaration of interim dividend. However the first proviso to Section 123(1) provides that a company may, before the declaration of any dividend in any financial year, transfer such percentage of its profit for that financial year as it may consider appropriate to the reserves of the company irrespective of the size of the declared dividend i.e. the company is not mandatorily required to transfer the profit to the reserves, it is an option available to the company to transfer such percentage.

In the instant case, the Board has decided to pay interim dividend @15% of the paid-up capital. Assuming that the company has complied with the depreciation requirement, the interim dividend can be declared without transferring such percentage of its profits as it may consider appropriate to the reserves of the company.

(b) Provisions: As per AS – 29, 'Provisions, Contingent Liabilities and Contingent Assets', a provision is a liability which can be measured only by using a substantial degree of estimation.

As per AS – 29, a provision should be recognised when:

1. An enterprise has a present obligation as a result of a past event.
2. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and
3. A reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

In the present case, V Ltd fulfils all the above conditions. The sale of pumps with a warranty obligation constitutes the present obligation as a result of past event. It is probable that some outflow will be involved in setting the warranty obligation, satisfy the second condition. As per the details based on past precedence reliable estimate can be made as under:

[6000 × (5% of 100000) + 1000 × (10% of 100000)] = ₹ 400 lakhs

Thus, V Ltd as on 31.3.07 should make a provision for warranty obligation against sale of vacuum pumps to the extent of ₹ 400 lakhs. The auditor should insist on such provision being created. If provision is not made he should qualify his audit report.

(c) Valuation of Inventories: AS 2 requires that inventories should be valued as lower of cost and Net realisable value (NRV). A departure from the general principle can be made if the AS is not applicable or having regard to the nature of industry.

AS 2 also states that (a) work in progress arising under construction contracts, including directly related service contracts (b) work in progress arising in the ordinary course of business of service providers;(c) shares, debentures and other financial instruments held as stock-in-trade; and(d) producers' inventories of livestock, agricultural and forest products are measured as NRV based on established practices.

In the given case the sale is assumed under a forward contract but the goods are not of a nature covered by the above exceptions Taking into account the facts the closing stock of finished goods should have been valued at cost, as it is lower than the realisable value (as it includes profit). Further, export cash incentives should not be included for valuation purposes.

The policy adopted by the company for valuing its closing stock of inventory of finished goods on selling price plus export incentives is not correct. The statutory auditor should give a qualified report.

Question 22

What are the steps to be taken by a firm of Chartered Accountant to ensure that its appointment as Statutory Auditor of a Company is valid? (6 Marks, May, 2008)

Answer

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

1. **Ceiling limit:** Ensure that a certificate has been issued under section 139 of the Companies Act, 2013 so that the total number of company audits held by the firm (including the new appointment) will not exceed the specified number.
2. **Resolution at AGM:** Verify that at AGM of the Company, a proper resolution is passed. Inspect general meeting minutes book to see that the appointment is duly recorded.
3. **Compliance with law:** Satisfy that the legal procedure contemplated in section 139 and 140 of the said Act, dealing with the appointment and removal of existing auditor, have been followed. Also check whether section 139(5) and 139(7) (in case of a government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments- appointment by the Comptroller and Auditor General of India) are attracted and complied with.
4. **Code of conduct:** Communicate with the previous auditor, if any, in writing, to ascertain if there are any professional reasons for not accepting the appointment.

Question 23

Write short notes on the following:

(a) Key Management Personnel

(b) Normal Capacity for the purpose of Inventory valuation

(c) Integral Foreign Operations *(4 Marks each, May, 2008)*

Answer

(a) Key management personnel: As per AS 18 on Related Party Disclosures, "Key management personnel" are those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

Further, Section 2(51) of the Companies Act, 2013 also defines the "key managerial personnel" in relation to a company as the Chief Executive Officer or the managing director or the manager; the company secretary; the whole-time director; the Chief Financial Officer; and such other officer as may be prescribed.

It may be noted here that non-executive directors of a company will not be considered as key management personnel under AS 18 by virtue of merely their being directors, unless they have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

Further, the requirements of AS 18 should not be applied in respect of a non-executive director even if he participates in the financial and/or operating policy decision of the enterprise unless he falls in any of the categories discussed in Para 3 of AS 18.

(b) Normal capacity for inventory valuation: As per AS 2 on Valuation of Inventories, allocations of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities.

Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. Due to this, the fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. In periods of high production, these overheads allocated are decreased so that inventories are not measured above cost.

(c) Integral Foreign Operations: As per AS 11 on The Effects of Changes in Foreign Exchange Rates, there are foreign operations, the activities of which are an integral part of the reporting enterprise. This is important since the method used to translate financial results of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise.

A foreign operation that is integral to the operation of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. In such cases, change in exchange rates between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rates affects the individual monetary items held by the foreign operation rather than the net investment in that operation.

Question 24

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

(a) Z Ltd. provided, ₹ 5 lakhs for inventory obsolescence in the last year's accounts. In the subsequent year, it was determined that 50% of this stock was actually usable. The Company wants to adjust the same as a "Prior period adjustment". *(5 Marks, November, 2007)*

(b) A company capitalises interest on borrowings incurred for holding investments by adding the same to the cost of investment every year. *(4 Marks, November, 2007)*

(c) X Ltd. is engaged in manufacture of Cement. In the Profit and Loss Account for the year ended 31st March, 2007, it discloses its revenue from sales transactions (turnover) net of excise duty. The excise duty collected and paid on sales transactions and that related to difference between Closing stock and Opening stock is, however, disclosed in the "Notes to Accounts". *(4 Marks, November, 2007)*

Answer

(a) Prior Period Adjustment: As per Accounting Standard 5 "Net Profit or Loss for the period, Prior Period Items and Change in Accounting Policies", Prior period items are income or expenditure 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.

An estimate may have to be revised -

(i) If changes occur in the circumstances on which the estimate was based or

(ii) 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.

A change in an accounting estimate may affect the current period only or both the current period and future periods. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

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

In this case, Z Ltd. provided ₹ 5 lakhs for inventory obsolescence in last year's accounts. 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 ₹ 2.5 lakhs within the definition either of a prior period item or of an extraordinary item. The amount, however, involved is material and requires separate disclosure to understand the financial position and performance of an enterprise. Accordingly, adjustment in the value of the inventory through prior period item would not be proper.

(b) Capitalisation of Interests: Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. As per AS-13 "Accounting for Investments", cost of investments includes acquisition charges such as brokerage, fees and duties. As per AS 16 "Borrowing Costs", borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Assets that are ready for their intended use or sale when acquired are not qualifying assets. Therefore such investment is not a qualifying asset, therefore interest cost of holding investments cannot be capitalized.

(c) Disclosure requirement of Excise Duty: As per Accounting Standard Interpretation – ASI 14 ' Disclosure of Revenue from Sales Transactions' (Revised) issued by ICAI in Aug 2006, the amount of turnover should be disclosed as follows on the face of the Statement of Profit and Loss:

Turnover (Gross)	XX
Less : Excise duty	XX
Turnover (Net)	XX

Further, the excise duty shown above should be the total duty except the duty related to the difference between closing stock & opening stock which should be recognized separately in the Statement of Profit and Loss, with an explanatory note in the notes to accounts to explain the nature of the two amounts of excise duty.

Since the company, X Ltd has not followed the above ASI 14, the auditor would have to qualify his report accordingly.

Question 25

What is the meaning of "Small and Medium sized Company" as per the Companies (Accounting Standards) Rules, 2006? *(8 Marks, November, 2007)*

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 26

Write short notes on Purchase method of Accounting for amalgamations.

(4 Marks, November, 2007)

Answer

Purchase method of Accounting for Amalgamation: As per AS 14 on Accounting for Amalgamations, there are two main methods of accounting for amalgamations i.e. the pooling of interests method and the purchase method. Under the purchase method in preparing the transferee company's financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company. Any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve. The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortization period should not exceed five years unless a somewhat longer period can be justified. Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company. The corresponding debit should be given to a suitable account head (e.g., 'Amalgamation Adjustment Account') which should be disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory

reserves is no longer required to be maintained, both the reserves and the aforesaid account should be reversed.

Question 27

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

(a) In the audit of ABC Private Limited, auditor came across cases of payments to Directors, whereby, expenses of a personal nature were re-imbursed. (5 Marks, May, 2007)

(b) The management of a limited company states that proposed dividend does not represent a liability and hence no provision need to be made-Comment. (4 Marks, May, 2007)

Answer

(a) Reimbursement of personal expenses of Director: All payments to Directors as remuneration or perquisites whether in the case of a public or private company are required to be authorised both in accordance with the Companies Act and Articles of Association of the company. Articles may provide that such remuneration require sanction of the shareholders either by ordinary or special resolution while in some cases it may require only approval of Directors. If the terms of appointment of a Director include payment of expenses of a personal nature, then such expenses can be incurred by the company; otherwise, no such expense can be incurred or reimbursed by the company. In the instant case the auditor has to ensure that the above is complied with, without which, if such expenses are paid, he has to disclose the fact in his report, as also in the accounts. In this regard attention is invited to section 143(1)(e) of the Companies Act, 2013 wherein auditor has to inquire into whether personal expenses have been charged to revenue.

(b) Provision for Proposed Dividend: The Schedule III to the Companies Act, 2013, requires disclosure of the amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share to be disclosed separately. It also requires separate disclosure of the arrears of fixed cumulative dividends on preference shares.

Further, as per AS 4 "Contingencies and Events Occurring After the Balance Sheet Date", there are events which, although take place after the balance sheet date are sometimes reflected in the financial statement because of Statutory requirement or because of their special nature and such item includes the amount of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered in the financial statements.

Hence, a question that arises is as to whether this means that proposed dividend is not required to be provided for when applying the Schedule III.

Keeping this in view and the fact that earlier the disclosure of provision for proposed dividend was statutory requirement as per Old Schedule VI to the Companies Act, 1956, hence it was an adjusting event as per AS 4 and was provided for. However, this statutory requirement has been changed to disclosure by way of notes as per Schedule III to the Companies Act, 2013. Therefore, provision for proposed dividend is a non-adjusting event.

In the instant case, management of the company states that the proposed dividend does not represent a liability hence, no entry has been passed in the books of the company. Contention of the directors for non provision as per Schedule III is correct since statutory compliance has been changed. Consequently, amount of proposed dividend should be disclosed by means of a note to the accounts.

Question 28

A company wants to amend its accounts after the completion of the audit and adoption of the Accounts by the Board, but before circulation to the shareholders. It requires its statutory auditor to report on the amended accounts. State the steps the statutory audit should adopt in such a situation. (8 Marks, May, 2007)

Answer

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

The Guidance Note on "Auditor's report on revised accounts of companies before circulation to shareholders" recommends that members, when called upon to issue a report on amended accounts for the same period due to amendments to the accounts, should ensure all copies of the original accounts and reports are returned to him, adequate disclosure about the revision of accounts already reported, appears as a specific note on the amended accounts. If the Statutory auditor is satisfied about the adequacy of disclosure, there may not be any further need for him to refer to the revision of balance sheet and/or the Statement of Profit and Loss in his report otherwise he has to refer to the revision in his report. However, if the Notes to accounts do not contain any note on the revision or if such a note is contained therein but not considered by the statutory auditor as adequately comprehensive, it will be the duty of the statutory auditor to refer to the fact of revision of the accounts in his report.

(**Note** - The answer to this question would be based on provisions of Section 131 of the Companies Act, 2013 which is yet to be notified.)

Question 29

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

(a) Mr.Rajesh is appointed as the auditor of NOIDA Travels Ltd. with audit fees of ₹ 35,000. He purchased air ticket from Delhi to Kolkata and back for ₹ 18,000 from the client for

his personal work and the amount remains unpaid at the end of the year as it is a general practice of the client to give credit to all. Mr. Rajesh claims that he does not incur any disqualification as contained in Section 226(3)(d) of the Companies Act.

(5 Marks, November, 2006)

(b) Apex Ltd., a well reputed manufacturing public limited company has made a contribution of ₹ 2.5 lacs during the financial year ended 31.3.06 to a political party for running a school, situated in the village, where most of the workers of the company reside. It is admitted that the benefit of the school is mostly for the children of the workers of the company. The company has not made any profits in the last four years.

(4 Marks, November, 2006)

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) **Restrictions regarding political contribution:** Section 182 of the Companies Act, 2013 deals with prohibitions and restrictions regarding political contributions. According to this section, a government company or any other company which has been in existence for less than three financial years cannot contribute any amount directly or indirectly to any political party. In other cases, contribution in any financial year should not exceed 7½ % of average net profits during the three immediately preceding financial years. The company in question has not made any profit in last four years and contributed ₹ 2.5 lacs during the year to a political party for running a school. This is violation of the provisions of Section 182 of the said Act although the children of its workers are benefited. The auditor would have to qualify his report stating the contravention of the provisions of the Companies Act.

Question 30

State the salient features of the directions to the auditors of Government companies issued by the Comptroller and Auditor General of India u/s 619(3) of the Companies Act, 1956 in relation to:

(i) Assets and Investments, and

(ii) Inventory and Contracting. *(8 Marks, November, 2006)*

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 31

Write short notes on Effect of uncertainties on revenue recognition.(4 Marks, November, 2006)

Answer

Effect of uncertainties on Revenue recognition: Para 9 of AS 9 "Revenue Recognition" deals with the effect of uncertainties on revenue recognition. The Para states:

(i) Recognition of revenue requires that revenue is measurable and at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.

(ii) Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g. for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases it may be appropriate to recognize revenue only when it is reasonably certain that the ultimate collection will be made. When there is no uncertainty as to ultimate collection, revenue is recognized at the time of sale or rendering of service even though payments are made by instalments.

(iii) When the uncertainty relating to collectability arises subsequent to the time of sale or rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

(iv) An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

(v) When recognition of revenue is postponed due to effect of uncertainties, it is considered as revenue of the period in which it is properly recognised.

Question 32

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

(a) A Pvt. Ltd., started stock broking activities in 2005. For this purpose it acquired membership of a stock exchange for ₹ 110 lacs. While finalizing the accounts, the company disclosed the above amount under the Fixed Assets schedule as "Stock Exchange Membership Rights". The company also did not write off any amount since the rights would enable the company to perpetually carry on its business.(5 Marks, May, 2006)

(b) ABC Ltd. having a paid up capital of ₹ 1 crore earned as total net profit of ₹ 1 crore for the years 2001-02 to 2003-04. The Company did not declare any dividend nor transferred any amount to Reserves for these years. The entire profit was retained in the Profit & Loss Account.

In 2004-05, the company made a profit of ₹ 20 lacs. The company also proposed in 2004-05 to declare dividend @25% out of accumulated profits. (4 Marks, May, 2006)

(c) XYZ Ltd. had received a grant of ₹ 50 lacs in 1997 from a State Government towards installation of pollution control machinery on fulfillment of certain conditions. The company, however, failed to comply with the said conditions and consequently was required to refund the said amount in 2005.

The company debited the said amount to its machinery in 2005 on payment of the same. It also reworked the depreciation for the said machinery from the date of its purchase and passed necessary adjusting entries in the year 2005 to incorporate the retrospective impact of the same. *(5 Marks, May, 2006)*

(d) C Ltd. holds shares of D Ltd. which also entitles it to 51% voting power. These shares are held as "Stock-in-Trade" since C Ltd.'s intention is to dispose them in the near future. Due to this, C Ltd. is of the view that the financial statements of D Ltd. need not be consolidated. (4 Marks, May, 2006)

Answer

(a) Stock Exchange Membership Rights: A Pvt. Ltd. has paid ₹ 110 lacs for acquiring membership of stock exchange. Such membership rights provide exclusive right to A Pvt. Ltd. for carrying out stock broking activities. Thus, Stock Exchange Membership Rights are controlled by A Pvt. Ltd. and provide the basis for generating economic benefits to it. All these criteria appear to meet the definition of intangible assets as laid down in AS 26, "Intangible Assets". The Standard requires an entity to recognize an intangible asset if it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise and the cost of the asset can be measured reliably. In the instant case, membership rights of stock exchange acquired by A Pvt. Ltd. meet the criteria of identifiability, control and arising of future benefits as well as reliability of the amount of cost. Thus recognizing the membership rights as Fixed Assets is proper.

However, the fact that the company did not write-off any amount since it would enable the company to perpetually carry on its business is not proper since AS 26 requires that all Intangible Assets to be amortised. For this purpose, a rebuttable presumption of 10 years is to be considered. Hence in the instant case, the company should have amortised such rights over 10 years. Since the company has not amortised any amount, the auditor will have to qualify his report and state the fact of non-compliance with AS 26.

(b) This question is redundant in view of the provisions of the Companies Act, 2013.

(c) Refund of Government Grant: As per facts of the case, XYZ Ltd. had received a grant of ₹ 50 lacs in 1997 from a State Government towards installation of pollution control machinery on fulfilment of certain conditions. However, the amount of grant has to be refunded since it failed to comply with the prescribed conditions. In such circumstances, AS 12, "Accounting for Government Grants", requires that the amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. The Standard further makes it clear that in the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset. Accordingly the accounting treatment given by XYZ Ltd. of increasing the value of the plant and machinery is quite proper. However, the accounting treatment in respect of depreciation given by the company of adjustment of depreciation with retrospective effect is improper and constitutes violation of both the AS 6, "Depreciation Accounting" and AS 12, "Accounting for Government Grants".

The auditor, therefore, should discuss with the management to make necessary changes in respect of same and if not agreed to, qualify the report quantifying the impact of the same on profit as well as assets of the company.

(d) Consolidation of Accounts: AS 21, "Consolidated Financial Statements", requires that a subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future. In this case it needs consideration as to whether C Ltd.'s intention is to dispose off shares or hold the same. Since shares are being held as 'stock-in-trade' and the intention is to dispose off in near future, it is quite clear that control is temporary. Accounting Standards Interpretation issued by the Institute of Chartered Accountants of India specifies that where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise would be considered temporary. Hence, in such a case, the concerned subsidiary should be excluded from consolidation. Therefore, the contention of the C Ltd. that D Ltd. can be excluded from consolidation is correct.

Question 33

Write short notes on the following:

(a) Remuneration to Statutory Auditors under the Companies Act, 1956

(b) Deferred Taxation (4 Marks each, May, 2006)

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) Deferred Taxation: AS 22 "Accounting for Taxes on Income", prescribes the accounting treatment for taxes on income. The amount of taxable income for a period and the amount of profit (or loss) as shown by the Statement of Profit and Loss for that period are seldom the same. The difference between accounting income and taxable income arise due to the fact that taxable income is calculated in accordance with tax laws whose requirements regarding computation of taxable income differ from the accounting policies applied to determine accounting income. The difference between taxable income and accounting income can be classified into 'permanent differences' and 'timing differences'. 'Permanent differences' are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently. Timing differences, on the other hand, are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. The standard requires that deferred tax should be recognized for all timing differences, subject to the consideration of prudence in respect of deferred tax assets. Deferred tax represents the future tax effects of timing differences. Some timing differences are such that their reversal in future year(s) would result in the taxable income for the year(s) of reversal being higher than the accounting income for that year (or those years).

Question 34

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

(a) ABC Ltd. commenced construction of a flyover in Mumbai in January, 2004 under BOLT scheme. The same was completed in February, 2005. Due to seasonal heavy rains in

July, 2004 in the area, the work on the flyover had to be suspended for 1 month. The company accordingly suspended borrowing costs of ₹ 12.50 lakhs for that month from capitalization. (5 Marks, November, 2005)

(b) P Ltd. of whom you are the Statutory Auditor appoints M/s XYZ as Branch Auditors for one of its branches. M/s XYZ conducted the audit of the branch without visiting the branch and instead getting the books at the H.O. M/s XYZ has submitted their Branch Audit Report to you. (5 Marks, November, 2005)

(c) LM Ltd. has 2 divisions L and M. The finished products of division L are transferred to division M where further processing is carried out before sale to customers. To achieve transparency and accountability between the divisions, division L raises an invoice on division M at cost plus normal margins. At the year end the unrealized profits on inter-division stocks are eliminated. However, the transfers are recorded at the invoice value as sales and purchases in the respective divisions for the purpose of preparing the Profit and Loss Account. Suitable disclosures, for this are given in then 'Notes to Accounts'. (5 Marks, November, 2005)

(d) T Pvt. Ltd. is an unlisted closely held company with turnover less than ₹ 50 crores. While finalizing the accounts, Mr. M the Director (finance) disputed the applicability of AS 20 to the company. (3 Marks, November, 2005)

Answer

(a) Capitalisation of Borrowing Costs: Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for intended use or sale are interrupted. According to AS-16, "Borrowing Costs", capitalisation of such borrowing costs should be suspended during extended periods in which active development is interrupted. The standard, however, clarifies that capitalisation of borrowing costs is not suspended when a temporary delay is necessary as a part of the process or substantial technical and administrative work is being carried out. Thus, the test as to whether or not to capitalise the borrowing costs depends primarily upon the nature of interruption of activities during "extended periods".

In the instant case, it has been mentioned that the construction activity was interrupted due to seasonal rain and hence being regular feature. Though the rain was heavy, the period cannot be considered as an "extended period" leading to substantial delay in suspension of construction activities. Therefore, borrowing cost of ₹ 12.50 lakhs incurred by ABC Ltd. should be capitalized. Hence, suspension of capitalization by the company is not a correct treatment and statutory auditor should report accordingly.

(b) Branch Auditor's Report: As per provisions of the Companies Act, 2013, the accounts of a branch office of a company are required to be audited either by the company's auditor or by any other person qualified for appointment as auditor of the company. It is not necessary for branch auditor M/s XYZ to visit the branch and conduct the audit only at branch's premises. It is a matter of professional judgement for the branch auditor to decide as to whether he needs to visit the branch. At the same time, the statutory auditor has the right to visit branch offices and to have access to the books of accounts and vouchers maintained at the branch office in this case.

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

(c) Revenue Recognition: As per the definition of the term "Revenue" in AS 9, "Revenue Recognition", revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them.

As per the clarification issued by ICAI, the use of the word "enterprise" in the above definition clearly implies that the transfers within the enterprise cannot be considered as fulfilling the definition of the term "revenue". Thus, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with AS 9. Further, in case of inter-divisional transfers, risks and rewards remain within the enterprise and also there is no consideration from the point of view of the enterprise as a whole. Thus, the recognition criteria for revenue recognition are also not fulfilled in respect of inter-divisional transfers.

In the instant case, therefore, LM Ltd cannot recognise inter-division transfers from L to M as sales and the same will have to be eliminated during finalisation. If not so done, the statutory another will have to qualify his report.

(d) Applicability of Accounting Standard: AS 20, "Earning Per Share", came into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. As such AS 20 does not mandate an enterprise, which has neither equity shares nor potential equity shares which are so listed, to calculate and disclose earnings per share, but, if that enterprise discloses earnings per share for complying with the requirements of any statute or otherwise, it should calculate and disclose earnings per share in accordance with AS 20. Part II of Schedule III to the Companies, Act, 2013, requires, among other things, disclosure of earnings per share. Accordingly, every company, which is required to give information under Part II of Schedule III to the Companies Act, 2013, should calculate

and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

Accordingly the company, T Pvt. Ltd should compute and disclose EPS according to AS 20. Therefore, the contention of Director (Finance) is incorrect. The auditor will have to ensure that EPS is disclosed as per AS 20 or else the auditor should appropriately modify the audit report.

Question 35

What are the statements of facts that an auditor has to report u/s 227 of the Companies Act, 1956? (4 Marks, November, 2005)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 36

Write short notes on Recognition of Deferred Tax Assets. (4 Marks, November, 2005)

Answer

Recognition of Deferred Tax Assets: Deferred Tax Assets (DTA) is to be recognised as laid down by AS 22 "Accounting for Taxes on Income". A DTA arises on account of a timing difference in which the taxable income is more than the book income. A deferred tax asset (and the corresponding tax saving) should be recognised only after applying the test of prudence. Thus, where the enterprise does not have unabsorbed depreciation and carried forward losses as per the tax laws, deferred tax assets should be recognised and carried forward to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realized. In other words, no deferred tax asset should be created if there is no reasonable certainty about the requisite future taxable income. The existence or absence of a reasonable level of certainty would normally be determined by examining the past record of the reasonable and by making realistic estimates of profits for the future.

A much stricter test of prudence has to be satisfied where the enterprise has unabsorbed depreciation or carried forward losses under tax laws. In such a situation, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realized. The existence of unabsorbed depreciation or carried forward losses under tax laws is strong evidence that future taxable income may not be available. Therefore, in such a situation, the enterprise can recognise deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient taxable income or there is other convincing evidence of virtual certainty of availability of sufficient taxable income against which deferred tax assets can be realized.

ICAI has stated that virtual certainty refers to the extent of certainty which, for all practical purposes, can be considered certain. Virtual certainty cannot be based merely on forecasts of performance such as business plans. Determination of virtual certainty of availability of sufficient future taxable income is a matter of judgement which will have to be made on a case-to-case basis.

Question 37

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

(a) P Pvt. Ltd. was amalgamated with PQR Ltd. with effect from 1st April, 2004. As per the scheme of amalgamation approved by the High Court, the amalgamation was to be accounted by the "Pooling of Interests Method". The scheme further provided that the balance in Revaluation Reserve of P Pvt. Ltd. as on 31st March, 2004 was to be treated as a General Reserve on amalgamation. During the financial year 2004-05, PQR Ltd. issued bonus shares out of General Reserves (which included the amount of revaluation reserve of P Pvt. Ltd.)

(b) B Pvt. Ltd., implements a Voluntary Retirement Scheme (VRS) for its employees. It follows a policy of amortising the expenditure over 10 years. As at 1st April, 2004, the unamortised VRS expenditure was ₹ 15 lakhs. During the year 2004-05, it incurred further ₹ 12 lakhs as VRS. For the year ended 31st March, 2005, the company proposes to revise the period of amortisation to 5 years. It also proposes to follow the revised period for the opening balance. (5 Marks each, May, 2005)

Answer

(a) Amalgamation and Revaluation Reserve: As per AS 14, "Accounting for Amalgamations" if the amalgamation is in the nature of merger and the 'Pooling of Interest Method' is followed, the identity of the reserves is preserved and it appears in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. In the instant case, P Pvt. Ltd is amalgamated with PQR Ltd. and the amalgamation is in the nature of merger. Accordingly, Revaluation Reserves of P Pvt. Ltd. would have normally continued to remain so in PQR Ltd. However, since the scheme mentions that Revaluation Reserve is to be treated as General Reserves, the scheme will override AS 14. AS 14, "Accounting for Amalgamations", also requires that in case of any approved scheme of amalgamation if the treatment in accounting is not as per the AS, a specific disclosure of the same will have to be made alongwith the financial effect on the financial statements due to such deviation. The statutory auditor will accordingly have to ensure that the company complies with the requirements regarding treatment of reserves and other related disclosure requirements or he may be required to modify his report.

(b) Expenditure on Voluntary Retirement Scheme: AS 26, "Intangible Assets", deals with expenditure incurred on intangible items by all enterprises, except amongst others, is not applicable to expenditure in respect of termination benefits. As per the standard, termination benefits are employee benefits payable as a result of either an enterprises' decision to terminate an employee's employment before the normal retirement date; or an employee's decision to accept voluntary redundancy in exchange for those benefits (voluntary retirement). Accordingly, Voluntary Retirement Scheme (VRS) is one form of termination benefit and hence AS 26 principles are not applicable. The same has to be,

therefore, accounted as per general accepted accounting practices. Accordingly, VRS expenditure would have to be written off / amortised over a reasonable period. In fact, the change of the accounting policy followed by the company to reduce the amortisation period to 5 years for the entire VRS expenditure including opening balance seems appropriate and reasonable. The auditor, however, has to examine that the requirements of AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" and impact of change in accounting policy is also disclosed as per AS 1, "Disclosure of Accounting Policies".

Question 38

You have been appointed the sole statutory auditor of a company where you were one of the joint auditors in the immediately preceding year. The concerned joint auditor has not been reappointed. What are the various steps you would take to ascertain the compliance of the requirements of the Companies Act, 1956 before accepting the audit? (5 Marks, May, 2005)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 39

When can a company be said to have 'Not maintained' proper books of account? What is the role of the statutory auditor for the same? (6 Marks, May, 2005)

Answer

Section 128(1) of the Companies Act, 2013 (herein after referred as the Act) requires that every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting. Further, the definition of "financial statement" in relation to a company, given under section 2(40) of the Act includes a balance sheet as at the end of the financial year; a profit and loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year; cash flow statement for the financial year (One Person company, small company and dormant company, may not include the cash flow statement); a Statement of changes in equity (if applicable); and any explanatory note annexed to, or forming part of, any of the document referred before.

Section 129(1) of the Act, requires that the financial statements shall give a true and fair view of the state of affairs of the company, comply with the accounting standards notified in this Act and shall be in the form as provided in Schedule III to this Act. It is also provided that the provisions contained in this sub-section shall not be applicable to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial; statement has been specified in or under the Act governing such class of company.

The provisions mentioned above are required to be followed by the company to maintain proper books of accounts. The Auditor is required to check that the company has complied with all the provisions related to maintenance of books of accounts etc.

Further, the books have to be maintained under accrual system and if the statutory auditor finds the books are not maintained accordingly, he will have to modify his report.

According to Section 143(3)(b), the auditor's report shall also state whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him.

If answer is in negative or with qualification, the report shall state the reasons therefor.

Question 40

A company has a branch office which recorded a turnover of ₹ 1,90,000 in the financial year 2004-05. No audit of the branch has been carried out. The statutory auditor of the company has made no reference of the above branch in his report. The total turnover of the company is ₹ 10 crores for the year 2004-05. Comment. (6 Marks, May, 2005)

Answer

As per section 143(8) of the Companies Act, 2013 if a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country.

Therefore, the company has to get its branch audited. In case no branch audit has been carried out, company's auditor is required to mention this fact in the audit report and deal appropriately.

Question 41

What are your views on the following:

(a) A Ltd. was under audit for the year ended 31.03.2004. An appeal filed by A Ltd. against the demand of Excise Duty of ₹ 26 crores was pending before the Supreme Court for which neither provision was made nor was disclosed in the notes to the financial statements. On 12th July, 2004, the auditor came to know through paper reports that the point involved in the appeal of A Ltd. was adjudicated by the Supreme Court in the case of some other assessee, which is in favour of the department of Excise Duty. The auditor insisted that provisions be made of ₹ 26 crores in the financial statements. The Management was of the view that since its own case is still pending, no provision is called for. It was also of the view that the event does not have any effect on the financial position of the company on the date of the Balance Sheet. Is the view of the Management tenable?

(b) Kevin Industries Ltd. has a paid up capital of ₹ 20 crores divided into equity shares of ₹ 10 each as on 31.03.2003. During the financial year 2003-04 it has issued bonus shares in the ratio 1 : 1. The net profit after tax for the years 31-03.2003 and 31.3.2004 is ₹ 10 crores and ₹ 15 crores respectively. The Earnings Per Share (EPS) disclosed in the financial statements for the above two years is ₹ 5.00 and ₹ 3.75 respectively. Is the disclosure correct?

(c) A firm of a father and a son is receiving ₹ 2 lakhs towards job work done for XYZ Ltd. during the year ended on 31.03.04. The total job work charges paid by XYZ Ltd. during the year are over ₹ 50 lakhs. The father is a Managing Director of XYZ Ltd. having substantial holding. The Managing Director told the auditor that since he is not involved in the activities of the firm and since the amount paid to it is insignificant; there is no need to disclose the transaction. He further contended that such a payment made in the last year was not disclosed. Is Managing Director right in his approach? (5 Marks each, November, 2004)

Answer

(a) Provision to be provided for in the Financial Statement: As per AS 29 "Provisions, Contingent liabilities and Contingent Assets", a contingent liability is a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

Further, 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 event will occur.

As per SA 570 “Going Concern”, there are certain examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy is one of the example of such event.

When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements adequately describe the principal events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern and management’s plans to deal with these events or conditions; and disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

Since the issue involved in the appeal of A Ltd. was similar to the point in case of some other company and since the appeal of that company was decided against that company and in favour of the Excise Department, it is necessary for A Ltd. to make a provision of ₹ 26 crores as per AS 29. The case settled by the Supreme Court on similar point reflects significant developments affecting the assessment about the potential risk faced by the company. The view of the management that its own appeal is undecided or that it has no effect on the financial position as on 31.03.2004 is not at all tenable. Since the financial position is materially affected, the auditor should express a qualified opinion or an adverse opinion as may be appropriate.

(b) Disclosure of Earnings Per Share: AS 20 on Earning Per Share (EPS) prescribes principles for the determination and presentation of EPS. As per AS 20, the earnings per share have to be disclosed as basic and diluted earnings per share on the face of the Statement of Profit and Loss for each class of equity shares that has a different right to share in the net profit for the period. In the instant case, Kevin Industries Ltd., both the basic as well as the diluted earnings per share would be the same since there are no dilutive instruments that have been issued by the company. As per AS 20, in the case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration and thus would lead to increase in number of equity shares without any adjustment to outstanding capital amount. Therefore, the number of equity shares outstanding is increased without an increase in resources. The standard further requires that the number of equity shares outstanding before the event of a bonus issue to be adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. Hence the EPS calculated as on 31-03-2003 would be Adjusted EPS and the same would be disclosed. In view of the above, the EPS will be calculated as under:

As on 31.03.2003

$$\frac{\text{Profits}}{\text{Adjusted No. of Shares}} = \text{Adjusted EPS}$$

$$\frac{10,00,00,000}{4,00,00,000} = ₹\ 2.5$$

As on 31.03.2004

$$\frac{\text{Profits}}{\text{No. of shares}} = \text{EPS}$$

$$\frac{15,00,00,000}{4,00,00,000} = ₹\ 3.75$$

Since the above figures of EPS have not been disclosed, Kevin Industries Ltd. has not complied with the provisions of AS 20. Therefore, the auditor would have to qualify his report in terms of section 143(3)(e) of the Companies Act, 2013.

(c) Related Party Disclosures: As per definition given in the AS 18 “ Related Party Disclosures” parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

In the instant case, the managing director of XYZ Ltd. is a partner in the firm with his son which has been paid ₹ 2 lakhs as job work charges. The managing director is having a substantial holding in XYZ Ltd. The case is squarely covered by AS 18. According to AS-18,

in the case of related party transactions, the reporting enterprise should disclose the following:

(i) the name of the transacting related party;

(ii) a description of the relationship between the parties;

(iii) a description of the nature of transactions;

(iv) volume of the transactions either as an amount or as an appropriate proportion;

(v) any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and

(vii) amounts written off or written back in the period in respect of debts due from or to related parties."

Further, SA 550 on "Related Parties", also prescribes the auditor's responsibilities and audit procedures regarding related party transactions.

The approach of the managing director is not tenable under the law and accordingly all disclosure requirements have to be complied with in accordance with the AS 18. Auditor should insist to make proper disclosure as per the AS and if management refuses, the auditor shall have to modify his report. Also it has to be seen whether section 184 of the Companies Act, 2013 regarding disclosure of interest by director has been complied with. If it is not complied with, the auditor needs to modify the report appropriately.

Question 42

Do you approve of the following? If not, why?

(a) Trimurthy Pan Masala (P) Ltd. was incurring heavy losses in the last several years since it could not withstand the competition in the market. The State in which the company had its registered office and also its major sales had moved a bill in the State Assembly to ban manufacture and sale of all kinds of Pan Masalas in the State. While finalizing the accounts for the year ended 31-03-2004, the CFO of the company created a Deferred Tax Asset for the tax benefits that would arise in future years from the earlier years losses that had remained unabsorbed in Income Tax.

(b) Big Ltd. has borrowed ₹ 30 lakhs from State Bank of India during the financial year 2003-04. The borrowings are used to invest in shares of Small Ltd., a subsidiary company of Big Ltd., which is implementing a new project estimated to cost ₹ 50 lakhs. As on 31st March, 2004, since the said project was not complete, the directors of Big Ltd. resolved to capitalize the interest accruing on borrowings amounting to ₹ 4 lakhs and add it to the cost of investments. (4 Marks each, November, 2004)

Answer

(a) Creation of Deferred Tax Asset: Accounting Standard 22 on "Accounting for Taxes" requires that Deferred Tax Asset (DTA) should be recognised for all timing differences, subject to the considerations of prudence. The Standard further states that unabsorbed losses of the business can be considered for creation of DTA provided there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such DTA can be realised. In view of this, the DTA created by the CFO of Trimurthy Pan Masala (P) Ltd. is not in order. Since the company which is in the business of manufacturing of *panmasala* has been incurring heavy losses and in addition to this the State in which the company is having its major sales is proposing the ban on sale and manufacture of pan masala, the statutory auditor would, therefore, have to qualify his report and mention the extent of amounts of loss and reserves which are under and overstated respectively.

(b) Capitalisation of Interest: As per AS 13 on "Accounting for Investments", the cost of investment includes acquisition charges such as brokerage, fees and duties. In the instant case, Big Ltd. has used borrowed funds for purchasing shares of its subsidiary company Small Ltd. ₹ 4 lakhs interest payable by Big Ltd. to State Bank of India can not be called as cost of investment. The Accounting Standard 16 on "Borrowing Costs" also does not consider investment in shares as qualifying asset that can enable a company to add the borrowing costs to investments. In the instant case, the statutory auditor would qualify his report by stating that the borrowing costs have been wrongly added to the cost of investments rather than charging them to Statement of Profit and Loss. The effect of the same on the profits for the year would also have to be mentioned.

Question 43

Miranda Spinning Mills Ltd. is a sick company and has accumulated losses of ₹ 10 crores. The company has ₹ 12 crores in its share Premium Account. The Management desires to adjust the accumulated losses against the share premium balance. Advise the company giving your reasons. (8 Marks, November, 2004)

Answer

Application of Share Premium Account: Section 52 of the Companies Act, 2013 (herein after referred as the Act) deals with the application of premium received on issue of shares. 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 of the premium received on those shares shall be transferred to an account called "Securities Premium Account" and the provisions of this Act relating to reduction of share capital of a company except as provided in this section shall apply as if the securities premium account was the paid up share capital of the company. Sub-section (2) of the said section provides that notwithstanding anything contained in sub-section (1), securities premium account may be applied by the company for issue of bonus shares; writing off the preliminary expenses; writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; in providing for the premium payable on redemption of any redeemable preference shares or any debentures of the company; for the

purchase of its own shares or other securities. In view of these provisions of the Companies Act, 2013, it is not permitted to adjust its accumulated losses against the securities premium account.

Question 44

(a) Section 274 of the Companies Act, 1956 is applicable to appointment of Directors. Briefly explain your duty as a statutory auditor in this connection. (8 Marks, November, 2004)

(b) A company has paid interim dividend at 10% based on its half-yearly performance while at the end of the year suffered a net loss. How you will deal with the matter in your audit report as a statutory auditor? (4 Marks, November, 2004)

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) Declaration of Interim Dividend: Section 123 of the Companies Act, 2013 permits declaration of interim dividend during any financial year out of the surplus in the profit and loss account and out of profits of the financial year in which such interim dividend is sought to be declared. Ordinarily based on the performance of the company and taking a conservative view, the Board of Directors of the company declare the interim dividends. Quite often the advice of the auditor is sought before declaring an interim dividend. When this is done, he should suggest that 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, bad debts and other contingencies, only then the proportion of profits which have to be distributed as interim dividend may be decided.

Since 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. 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 the free reserves. The second proviso to Section 123(1) of the Companies Act, 2013 provides that, in the case of inadequacy or absence of profits in any year, dividends may be declared out of reserves. This can be done after the fulfilment of certain conditions as prescribed in Companies (Declaration and Payment of Dividend) Rules, 2014 like the rate of dividend declared shall not exceed the average of the rates at which dividend was declared by it in the three years immediately preceding that year; total amount to be drawn from such accumulated profits shall not exceed an amount equal to one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement; the balance of reserves after such withdrawal shall not fall below 15% of its paid-up share capital as appearing in the latest audited financial statement etc. If, however, there is no balance in the profit and loss account nor any reserves were available, the dividend would be clearly paid out of capital. The auditor would have to qualify his report mentioning the fact of the dividend having been paid out of capital.

Question 45

Write short notes on Responsibility of Joint Auditors. (4 Marks, November, 2004)

Answer

Responsibility of Joint Auditors: SA 299 on, "Responsibility of Joint Auditors" deals with the professional responsibilities which the auditors undertake in accepting such appointments as joint auditors. The responsibilities of joint auditors, as a rule are no different from the responsibilities of individual auditors as enumerated in the Companies Act. Main features of the said SA are discussed below:

- *Division of Work:* Where joint auditors are appointed, they should, by mutual discussion, divide the audit of identifiable units or specified areas. Certain areas of work, owing to their importance or owing to the nature of work involved would not be divided and would be covered by all the joint auditors. Such a division affected by the joint auditors should be adequately documented and preferably communicated to the auditee.
- *Coordination:* Where in the course of his work, a joint auditor comes across matters which are relevant to the areas of other joint auditors and which require joint discussion, he should communicate the same to all the other joint auditors in writing before the finalisation of audit and preparation of audit report.

In respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

(a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.

(c) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(d) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(e) for ensuring that the audit report complies with the requirements of the relevant statute.

(f) It is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit.

(g) The responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors.

(h) Each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

Normally, the joint auditors are able to arrive at an agreed report. However where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

Question 46

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

In the books of accounts of M/s OPQ Ltd. huge differences are noticed between the control accounts and subsidiary records. The Chief Accountant informs that this is common due to huge volume of business done by the company during the year. (4 Marks, May, 2004)

Answer

Difference between Control Accounts and Subsidiary Records: The huge differences found between control accounts and subsidiary records in the books of M/s OPQ Ltd. indicate that there may be material misstatements requiring detailed examination by the auditor to ascertain the cause. The contention of Chief Accountant cannot be accepted simply because the company has done huge volume of business. Such a phenomenon indicates that recording of transactions is not being done properly or the accounting system in the company which might have several branches spread over the country fails to capture all transactions in time. It would also be interesting to see whether it is a recurring phenomenon or such reconciliation could not be done at a subsequent date. Having regard to all these circumstances, it appears from the facts of the case that these differences indicate the possibility of some kind of material misstatements. As per SA 240, "The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements", 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. When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit.

Question 47

State the salient features of Investor's Education and Protection Fund. (8 Marks, May, 2004)

Answer

Salient features of Investors Education and Protection Fund: Section 205C of the Companies Act, 1956 empowers the Central Government to establish a fund to be called the Investor Education and Protection Fund to be utilized for the promotion of investor awareness and protection of the interest of the investors. The following amounts shall be credited to the fund, namely,

(a) amounts in unpaid dividends accounts of companies;

(b) matured deposits with companies;

(c) application moneys received by companies for allotment of any securities and due for refund;

(d) matured debentures with companies;

(e) interest, if any, accrued on the above items, i.e. (a) to (d);

(f) grants and donations given to the Fund by the Government or any other institutions, etc.

(g) the interest or other incomes received out of the investments made from the fund.

It may be noted that in respect of four items, i.e., unpaid dividends, application moneys, matured deposits and debentures shall be transferred to Fund only if such amounts shall remained unclaimed and unpaid for seven years from the date they became due for payment.

In fact, after lapses of seven years, no claims are tenable against the company or the Fund.

(**Note** - The answer to this question would be based on provisions of Section 125 of the Companies Act, 2013 which is yet to be notified.)

Question 48

Write short explanatory notes on the following:

(a) Treatment of foreign currency monetary items on balance sheet date

(b) Areas of propriety audit under Section 227(1A) of the Companies Act, 1956.

(4 Marks each, May, 2004)

Answer

(a) Foreign Currency Monetary Items and its Treatment on Balance Sheet date: As per AS 11 on "The Effects of Changes in Foreign Exchange Rates" monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money, e.g., cash, receivable, payables, etc. Regarding foreign currency transactions, AS 11 requires that while reporting effects of changes in exchange rates subsequent to initial recognition, at each balance sheet date, monetary items denominated in a foreign currency, (e.g., foreign currency notes, balances in bank accounts denominated in a foreign currency, and receivables, payables and loans denominated in a foreign currency) should be reported using the closing rate prevailing on balance sheet date. However in certain circumstances the closing rate may not reflect, with reasonable accuracy, the amount in reporting currency that is likely to be realized from or required to be disbursed to because the rate is unrealistic. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realized from or required to be disbursed to at the balance sheet date.

(b) This question is redundant in view of the provisions of the Companies Act, 2013.

7

Liabilities of Auditors

Question 1

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.

(iii) Based upon the legal opinion of a leading advocate, X Ltd. made a provision of ₹ 5 crores towards Income Tax liability. The assessing authority has worked out the liability at ₹ 5 crores. It is observed that the opinion of the advocate was inconsistent with legal position with regard to certain revenue items.

Answer

(i) Under section 35 of the Companies Act, 2013-

(1) Where a person has subscribed for securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person who—

(a) is a director of the company at the time of the issue of the prospectus;

(b) has authorized himself to be named and is named in the prospectus as a director of the company, or has agreed to become such director, either immediately or after an interval of time;

(c) is a promoter of the company;

(d) has authorised the issue of the prospectus; and

(e) is an expert referred to in sub-section (5) of section 26, shall, without prejudice to any punishment to which any person may be liable under section 36, be liable to pay compensation to every person who has sustained such loss or damage.

(2) No person shall be liable under sub-section (1), if he proves—

(a) that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent, or

(b) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.

(3) Notwithstanding anything contained in this section, where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, every person referred to in subsection (1) shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus.

Under section 448, 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 and also with fine as provided under section 447 of the said Act.

(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:

(a) Whether the defalcation emanated from the weaknesses noticed by the statutory auditor, the information regarding which was passed on to the management; and

(b) 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.

The fact that the matter was brought to the notice of the managing director may be a good defence for the auditor as well. According to the judgement of the classic case In re Kingston Cotton Mills Ltd., (1896) it is the duty of the auditor to probe into the depth only when his suspicion is aroused. The statutory auditor, by bringing the weakness to the notice of the managing director had alerted the management which is judicially held to be primarily responsible for protection of the assets of the company and can put forth this as defence against any claim arising subsequent to passing of the information to the management. In a similar case S.P. Catterson & Sons Ltd. (81 Acct. L. R.68), the auditor was acquitted of the charge.

(iii) SA 620 on "Using the Work of an Auditor's Expert" discusses the auditor's responsibility in relation to and the procedures the auditor should consider in, using the work of an expert as audit evidence. During the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert, e.g., legal opinions concerning interpretations of agreements, statutes, regulations, notifications, circulars, etc. Before relying on advocate's opinion, the auditor should have seen that opinion given by the expert is *prima facie* dependable. The question states very clearly that the opinion of the advocate was inconsistent with legal position with regard to certain items. It is, perhaps, quite possible that auditor did not seek reasonable assurance as to the appropriateness of the source data, assumptions and methods used by the expert properly.

In fact, SA 620 makes it incumbent upon the part of the auditor to resolve the inconsistency by discussion with the management and the expert .In case, the expert's' work does not support the related representation in the financial information the inconsistency in legal opinions could have been detected by the auditor if he had gone through the same. This seems apparent having regard to wide difference in the liability worked out by the assessing authority. Under the circumstance, the auditor should have rejected the opinion and insisted upon making proper provision.

Question 2

Write a short note on - Auditor's liability in case of unlawful acts or defaults by clients.

Answer

Auditor's liability in case of unlawful Acts or defaults by clients: The auditor's basic responsibility is to report whether in his opinion the accounts show a true and fair view and in discharging his responsibility he has to see as to how the particular situations affected his position. The general thinking with regard to unlawful acts or defaults by clients appears to be that the auditor should not 'aid or abet' but he is apparently not under any legal obligation to disclose the offence. A professional accountant would himself be guilty of a criminal offence if he advises his client to commit any criminal offence or helps or encourages in planning or execution of the same or conceals or destroys evidence to obstruct the course of public justice or positively assists his client in evading prosecution. A professional accountant in his capacity as auditor, accountant, or tax representative has access to a variety of information concerning his clients. On some occasions, he may acquire knowledge that his client has been guilty of some unlawful act, default, fraud, or other criminal offence. The duty of the professional accountant in such a case would depend upon the actual circumstances of the situation. Due consideration should be given to the exact nature of services that a professional accountant is rendering to his client, i.e. is he representing the client in income-tax proceedings or is he acting in the capacity of an auditor or an accountant or a consultant.

The Institute of Chartered Accountants of India has considered the role of chartered accountants in relation to taxation frauds by an assessee and has made the following major recommendations:

(i) A professional accountant should keep in mind the provisions of Section 126 of the Evidence Act whereby a barrister, an attorney, a pleader or a Vakil is barred from disclosing any communication made to him in the course of and for the purpose of his employment.

(ii) If the fraud relates to past years when the accountant did not represent the client, the client should be advised to make a disclosure. The accountant should also be careful that the past fraud does not in any way affect the current tax matters.

(iii) In case of fraud relating to accounts examined and reported upon by the professional accountant himself, he should advise the client to make a complete disclosure. In case the client refuses to do so, the accountant should inform him that he is entitled to dissociate himself from the case and that he would make a report to the authorities that the accounts prepared or examined by him are unreliable on account of certain information obtained later. In making such a report, the contents of the information as such should not be communicated unless the client consents in writing.

(iv) In case of suppression in current accounts, the client should be asked to make a full disclosure. If he refuses to do so, the accountant should make a complete reservation in his report and should not associate himself with the return.

However, it can be argued that the auditor has a professional obligation to ensure that the client is fully aware of the seriousness of the offence and to seriously consider full disclosure of the matter.

It has been clearly established in various case laws that the auditor is expected to know the contents of documents and records and ascertain whether the affairs of the client are being conducted in an unlawful manner. It is in the course of the work, he comes across any unlawful acts, it is his duty to bring it to the notice of the client as also to make a disclosure in his report in appropriate cases. In this regard, one has to bear in mind the consequence of the act in relation to the professional code to which an auditor is subjected. Under the code, an auditor cannot disclose confidential information unless

permitted by the client or unless required by law. Each case has to be judged on its circumstances. However, in every case he has to assess the implications of the unlawful act or default on the true and fair character of the accounting statements.

The question of liability of an auditor for unlawful acts or defaults by clients should be considered in the light of the broad parameters given above. However, it appears that if an auditor was aware of any unlawful act having been committed by client in respect of accounts audited by him and the unlawfulness was not rectified by proper disclosure or any other appropriate means, the auditor owes a duty to make a suitable report. If he does not, he may be held liable, if the true and fair character of the accounts has been vitiated.

Question 3

"Auditor's liability to third parties in relation to issue of Prospectus". Discuss.

Answer

Under section 35 of the Companies Act, 2013-

(1) Where a person has subscribed for securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person who—

(a) is a director of the company at the time of the issue of the prospectus;

(b) has authorized himself to be named and is named in the prospectus as a director of the company, or has agreed to become such director, either immediately or after an interval of time;

(c) is a promoter of the company;

(d) has authorised the issue of the prospectus; and

(e) is an expert referred to in sub-section (5) of section 26,shall, without prejudice to any punishment to which any person may be liable under section 36, be liable to pay compensation to every person who has sustained such loss or damage.

(2) No person shall be liable under sub-section (1), if he proves—

(a) that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent; or

(b) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.

(3) Notwithstanding anything contained in this section, where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, every person referred to in subsection (1) shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus.

Question 4

Explain briefly duties and responsibilities of an auditor in case of material misstatement resulting from Management Fraud.

Answer

Duties & Responsibilities of an auditor in case of Material misstatement resulting from management fraud: Misstatement in the financial statements can arise from fraud or error. The term fraud refers to an 'Intentional Act' by one or more individuals among management, those charged with governance. The auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements.

Fraud involving one or more members of management or those charged with the governance is referred to as "management fraud". The primary responsibility for the prevention and detection of fraud rests with those charged with the governance and the management of the entity.

Further an audit conducted in accordance with the standards on auditing generally accepted in India, is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement whether caused by error or fraud. The fact that an audit is carried out may act as deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of financial statements will not be detected, even though the audit is properly planned and performed in accordance with the standards on auditing generally accepted in India. An audit does not guarantee that all material misstatement will be detected because of such factors, as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.

Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees. Auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, hence in an audit, the auditor does not guarantee that material misstatements, will be detected.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 5

Explain the liability of the auditor under section 35 of the Companies Act, 2013, for making an untrue statement in the report (as an expert forming a part of the prospectus).

Answer

Under section 35 of the Companies Act, 2013-

(1) Where a person has subscribed for securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person who—

(a) is a director of the company at the time of the issue of the prospectus;

(b) has authorized himself to be named and is named in the prospectus as a director of the company, or has agreed to become such director, either immediately or after an interval of time;

(c) is a promoter of the company;

(d) has authorised the issue of the prospectus; and

(e) is an expert referred to in sub-section (5) of section 26, shall, without prejudice to any punishment to which any person may be liable under section 36, be liable to pay compensation to every person who has sustained such loss or damage.

(2) No person shall be liable under sub-section (1), if he proves—

(a) that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent; or

(b) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.

(3) Notwithstanding anything contained in this section, where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, every person referred to in subsection (1) shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus.

Question 6

In assessment procedure of M/s Cloud Ltd., Income Tax Officer observed some irregularities. Therefore he started investigation of Books of Accounts audited and signed by Mr. Old, a practicing Chartered Accountant. While going through books he found that M/s Cloud Ltd. used to maintain two sets of Books of Accounts, one is the official set and other is covering all the transactions. Income Tax Department filed a complaint with the Institute of Chartered Accountants of India saying Mr. Old had negligently performed his duties. Comment.

Answer

Liability of Auditor: "It is the auditor's responsibility to audit the statement of accounts and prepare tax returns on the basis of books of accounts produced before him. Also if he is satisfied with the books and documents produced to him, he can give his opinion on the basis of those documents only by exercising requisite skill and care and observing the laid down audit procedure.

In the instant case, Income tax Officer observed some irregularities during the assessment proceeding of M/s Cloud Ltd. Therefore he started investigation of books of accounts audited and signed by Mr. Old, a practicing Chartered Accountant. While going through the books, he found that M/s Cloud Ltd. Used to maintain two sets of Books of Accounts, one is the official set and other is covering all the transactions. Income Tax Department filed a complaint with the ICAI saying Mr. Old had negligently performed his duties.

Mr. Old, the auditor was not under a duty to prepare books of accounts of assessee and he should, of course, neither suggest nor assist in the preparations of false accounts. He is responsible for the books produced before him for audit. He completed his audit work with official set of books only.

In this situation, as Mr. Old, performed the auditing with due skill and diligence; and, therefore, no question of negligence arises. It is the duty of the Department to himself investigate the truth and correctness of the accounts of the assessee.

7
Liabilities of Auditors

Question 1

Mr. X, a young chartered accountant, wants to start practice and he requires your advice, among other things, on criminal liabilities of an auditor under the Companies Act, 1956. Kindly guide him. *(4 Marks, November, 2013)*

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 2

Explain the liability of the auditor under section 62 of the Companies Act, 1956, for making an untrue statement in the report (as an expert forming a part of the prospectus).

(5 Marks, May, 2010)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

8
Audit Report

Question 1

Write a short note on - Reporting on the compilation engagement.

Answer

SA 4410 "Engagements to Compile Financial Information": The objective of a compilation engagement is to use accounting expertise, as opposed to auditing expertise, to collect, classify and summarise financial information, This ordinarily entails reducing detailed data to a manageable and understandable form without the requirement to test the assertions underlying that information. The procedures employed are not designed and do not enable the member to express any opinion on the financial information. Therefore, it is essential that the member clearly brings out the nature of association with the financial statement and the nature of the work performed by him. The following may be noted in this regard.

(i) The title of the report should be "Accountant's Report on Unaudited Financial Statement and not An Auditor's Report".

(ii) The report should be addressed to the appointing authority.

(iii) The report should identify the financial information compiled, also stating that it is based on the information provided by the management.

(iv) The report should clearly state that the financial statements are not audited.

(v) In describing the engagement, ambiguous terms such as review, general review, check, etc. should not be based.

(vi) Date of the report should be mentioned.

(vii) Name and address of the firm of the member appointed for carrying out the compilation engagement should be mentioned.

(viii) Signature and the designation (sole proprietor/ partner) and membership number should appear in the report.

Question 2

Write a short note on- Emphasis of matter paragraph in Audit Reports.

Answer

Emphasis of matter paragraph in audit reports: An auditor's report can be modified for matters that do not affect the auditor's opinion. An "emphasis of matter" paragraph is such a type of notification in an audit report. In certain circumstances, such a paragraph is added to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such a paragraph does not affect the auditor's opinion. Such a paragraph is preferably included preceding the opinion paragraph and would ordinarily refer to fact that the auditor's opinion is not quantified in this respect. (Refer SA 700).

An illustration of an emphasis of matter paragraph for a significant uncertainty in an auditor report is as follows:

"Without qualifying our opinion, we draw attention to note X of schedule to the financial statements. The entity is the defendant in a lawsuit alleging infringement of certain patent right and claiming royalties and punitive damages. The entity has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate of the matter can not presently be determined, and no provision for any liability, that may result, has been made in the financial statements."

Question 3

Under the applicable Standards on Auditing, in what circumstances does the report of the statutory auditor require modifications? What are the types of modifications possible to the said report?

Answer

Modifications in Audit Report: As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", the auditor may modify the opinion in the auditor's report in the following circumstances:

(i) If the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

(ii) If the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with SA 705.

Types of Modification to the Auditor's Opinion: As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", modified opinion may be defined as a qualified opinion, an adverse opinion or a disclaimer of opinion.

Types of modifications possible to the said report are below-mentioned:

(i) **Qualified Opinion:** The auditor shall express a qualified opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the

financial statements of undetected misstatements, if any, could be material but not pervasive.

(ii) **Adverse Opinion:** The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

(iii) **Disclaimer of Opinion:** The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

Question 4

Beta Limited, is a company registered with SEBI, having five subsidiaries.

M/s XYZ, Chartered Accountants, have been appointed as Statutory Auditors for the audit of the Consolidated Financial Statements for the year ending March 31, 2014. Out of five subsidiaries, the audit of one subsidiary was conducted by another auditor, M/s Badnam and Company, Chartered Accountants. The "Opinion" para of audit report furnished by M/s XYZ Chartered Accountants is given below:

Opinion

In our opinion and to the best of our information and according to the explanations given to us the consolidated financial statements give a true and fair view, except the financial statement of one subsidiary whose accounts were audited by M/s Badnam and Company, Chartered Accountants and about the same we are not in a position to express our opinion as the audit has not been performed by us:

(i) in the case of the consolidated Balance Sheet, of the state of affairs of the Company as at March 31, 2014.

(ii) in the case of the consolidated Statement of Profit and Loss, of the profit/loss for the year ended on that date.

Do you find any deficiencies in the opinion para? If yes, you are required to give your suggestions and redraft the opinion para.

Answer

Opinion Para and Other Matter Para: Yes, the opinion para contains the following deficiencies-

(a) Out of five subsidiaries, the audit of one subsidiary was conducted by another auditor, M/s Badnam and Company which would be reported in other matter para.

(b) After point no. (ii) in the opinion para, point no. (iii) would appear as under-

"in the case of the consolidated Cash Flow Statement, of the cash flows for the year ended on that date."

The redrafted opinion para and other matter para are given hereunder as per SA 706 on Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report -

Opinion Para

In our opinion and to the best of our information and according to the explanations given to us and based on the consideration of the reports of the other auditors on the financial statements of the subsidiaries as noted below, the consolidated financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

(i) in the case of the consolidated Balance Sheet, of the state of affairs of the Company as at March 31, 2014;

(ii) in the case of the consolidated Statement of Profit and Loss, of the profit/ loss for the year ended on that date; and

(iii) in the case of the consolidated Cash Flow Statement, of the cash flows for the year ended on that date.

Other Matter Para

We did not audit the financial statements of one subsidiary, whose financial statements reflect total assets (net) of ₹ XXXX as at March 31, 2014, total revenues of ₹ XXXX and net cash outflows amounting to ₹ XXXX for the year then ended. These financial statements have been audited by other auditors M/s Badnam and Company, Chartered Accountants whose reports have been furnished to us by the Management, and our opinion is based solely on the reports of the other auditors. Our opinion is not qualified in respect of this matter.

Question 5

X Ltd closed its manufacturing operations and sold all its manufacturing fixed assets during the financial year ended 31st March, 2014. However it intends continue its operations as a trading company. In respect of other fixed assets, the company carried out a physical verification as at the end of 31st March, 2014 and found a material discrepancy to the tune of ₹ 1 lac, which was written off and is disclosed separately in the Statement of Profit and Loss. Kindly incorporate the above in your audit report.

Answer

Disclosure in Audit Report: As per SA 570 "Going Concern", when the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements-

(i) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(ii) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

In the given case, X Ltd. has sold out its manufacturing fixed assets during the year. However, it intends to continue its operations as a trading company. Therefore, selling of manufacturing fixed assets does not affect the going concern assumption of the company. Additionally, while carrying out physical verification of fixed assets, a material discrepancy to the tune of ` 1 lac was found, which was written off and disclosed separately in the Statement of Profit and Loss. Hence, this fact needs to be disclosed in the Audit Report as follows:

Para in the Audit Report-

We have made our viewpoint from the facts of the case and on the basis of guidance drawn from AS 1. We report as under-

As per Accounting Standard (AS) 1, "Disclosure of Accounting Policies", "the enterprise is normally viewed as a going concern that is as continuing its operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations." Although the company has disposed off its manufacturing fixed assets during the financial year ending on 31-03-2014, it is still a going concern in the form of a trading company. We also report that on physical verification of other fixed assets, a material discrepancy to the tune of ₹ 1 Lac was noticed and that the same has been properly dealt with in the books of account.

Question 6

XYZ Pvt. Ltd. has submitted the financial statements for the year ended 31-3-14 for audit. The audit assistant observes and brings to your notice that the company's records show following dues:

Income Tax relating to Assessment Year 2010-11 ₹ 125 lacs - Appeal is pending before Hon'ble ITAT since 30-9-12.

Customs duty ₹ 85 lakhs - Demand notice received on 15-9-13 but no action has been taken to pay or appeal.

As an auditor, how would you bring this fact to the members?

Answer

Non-Compliance of Laws and Regulations: As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statement", it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statements.

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 "Provisions, Contingent Liabilities and Contingent Assets", partly to the extent the company considers 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 the members by reporting.

Additionally, the demand notice has been received for Customs duty of ₹ 85 lakhs and is outstanding on the closure of financial year, for which no action has been taken by the management. Therefore, it should also be brought to notice of the members by reporting.

Question 7

ABC Private Ltd. has granted loan of ₹ 20 crores to XYZ Ltd. a sister concern and it remains outstanding at the year end. How would you report the fact?

Answer

Reporting of "Loan to Related Party": As per AS 18 "Related Party Disclosures", related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged. According to this AS, in the case of related party transactions, the reporting enterprise should disclose the following-

(i) the name of the transacting related party;

(ii) a description of the relationship between the parties;

(iii) a description of the nature of transactions;

(iv) volume of the transactions either as an amount or as an appropriate proportion;

(v) any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and

(vii) amounts written off or written back in the period in respect of debts due from or to related parties."

In the instant case, ABC Pvt. Ltd. has granted a loan of ₹ 20 crores to XYZ Ltd., a sister concern, and it remains outstanding at the year end. The case is squarely covered by AS 18.

Further, SA 550 on "Related Parties", also prescribes the auditor's responsibilities and audit procedures regarding related party transactions. Auditor should insist to make proper disclosure as per the AS and if management refuses, the auditor shall have to modify his report.

Question 8

(a) *OK Ltd. has taken a term loan from a nationalized bank in 2009 for ₹ 200 lakhs repayable in five equal instalments of ₹ 40 lakhs from 31st March, 2010 onwards. It had repaid the loans due in 2010 & 2011, but defaulted in 2012, 2013 & 2014. As the auditor of OK Ltd. what is your responsibility assuming that company has sought reschedulement of loan?*

(b) *Big and Small Ltd. received a show cause notice from central excise department intending to levy a demand of ₹ 25 lakhs in December 2013. The company replied to the above notice in January 2014 contending that it is not liable for the levy. No further action was initiated by the central excise department upto the finalization of the audit for the year ended on 31st March, 2014. As the auditor of the company, what is your role in this?*

(c) *Director of T Ltd. draws an advance of US$ 200 per day in connection with the foreign trip undertaken on behalf of the company. On his return he files a declaration stating that entire advance was expended without any supporting or evidence. T Ltd. books the entire expenses on the basis of such declaration. As the auditor of T Ltd. how do you deal with this?*

Answer

(a) ***As per the concept of Propriety and Performance Audit, the auditors of a company has to report if the Company has defaulted in repayment of its dues to financial institutions or bank or debentures holders and if yes the period and amount of default to be reported.***

In this case, OK Ltd. has defaulted in repayment of dues for three years. Application for rescheduling will not change the default position. Hence the auditor has to report in his audit report that the Company has defaulted in its repayment of dues to the bank to the extent of ₹ 120 lakhs.

(b) ***Non-Compliance of Laws and Regulations: As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statement", it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.***

If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statements.

In the present case issuance of show cause notice by Excise Department does not tantamount to demand payable by the Company. In so far as the Company has replied to the notice and no further correspondence was received from the Department, it has to be construed that there is no demand. Therefore, the auditor needs not to report on this.

Audit Evidence: SA 500 "Audit Evidence" states that an auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base his option.

Section 143(1)(e) the Companies Act, 2013 requires an auditor to enquire whether personal expenses have been charged to revenue account.

In the context of the facts of case, ascertain whether the payment made by the company for the foreign trip form an "allowance" or "reimbursement". An allowance is a fixed sum of money allowed or the basis of specified criteria. No evidence supporting the expenditure is required for payment of allowance to the director. On the other hand, if the payment is reimbursement should be against actual expenditure.

The director concerned should provide proof of expenditure. Since the director has given only a declaration, the auditor should ascertain other relevant facts as to whether the advance paid is pursuant to the policy of the company which is based on approximate estimation of the expenditure normally incurred by a person of the status of a director and the same is applicable to persons of a similar status within the company. If the auditor considers the advance taken is reasonable then the declaration can be considered adequate, otherwise he may have to call for additional documentary evidences.

Question 9

(a) Mr. X, Director of ABC Ltd. made a purchase contract for ₹ 10,00,000 with the company. Comment.

(b) PQR Ltd., a listed company and having an average annual turnover of more than ₹ 5 crores has no Internal Audit System. Give your views.

Answer

(a) ***Responsibility of Auditor in relation to the Companies Act 2013: As per Section 188 of the Companies Act, 2013, no company shall enter into any contract or arrangement with a related party to sale, purchase or supply of any goods or materials, except with the consent of the Board of Directors given by a resolution at a Board Meeting. Further, it is provided that no contract or arrangement, in the case of a company having specified paid-up share capital, or transactions exceeding prescribed sum, shall be entered into except with the prior approval of the company by a special resolution.***

The contracts or arrangements mentioned above are those for which the register(s) are maintained under section 189 of the Companies Act, 2013. The scope of the auditor's inquiry under this clause is restricted to such transactions referred to in sections 184 and 188 of the Act.

The auditor should, while reporting, in the first instance, determine whether the aggregate value of all the transactions entered into with any of the companies/firms/parties covered in the register maintained under section 189 of the Act exceed the value of rupees five lakhs in the year. If so, the auditor has to examine whether each of the transactions entered into with such a company/firm/party have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time. Further, the auditor while reporting should clearly bring out the reasons as to why no adverse comment was considered necessary.

The contracts referred to in section 188 are for sale, purchase or supply of any goods, materials or services and contract of underwriting the subscription of any securities or derivatives of the company between a Company and its director or, its relative, a firm in which the director or relative is a partner, any other partner in such a firm or a private company of which the director is a member or director. The auditor will have to obtain the list of such parties which are covered by section 188 mentioned above.

Hence, the auditor should ensure that all the above mentioned provisions have been compiled with.

(b) ***Internal Audit System: As per section 138 of the Companies Act, 2013, the following class of companies (prescribed in rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely-***

- ***(1) every listed company;***
- ***(2) every unlisted public company having-***
  - ***(i) paid up share capital of fifty crore rupees or more during the preceding financial year; or***
  - ***(ii) turnover of two hundred crore rupees or more during the preceding financial year; or***
  - ***(iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or***
  - ***(iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and***
- ***(3) every private company having-***
  - ***(i) turnover of two hundred crore rupees or more during the preceding financial year; or***
  - ***(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.***

In the instant case, PQR Ltd is a listed company and having an average annual turnover of more than ₹ 5 crores. As the company is a listed company, the provisions related to internal audit shall be applicable to the company. The turnover limit given has no relevance here. Therefore, the auditor will have to mention in his report the fact of not having such internal audit system by the Company.

Question 10

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

(a) PQR Ltd. has not deposited Provident Fund contribution of ₹ 10 lakhs with the authorities till the year-end.

(b) LM Ltd. had obtained a Term Loan of ₹ 300 lakhs from a bank for the construction of a factory. Since there was a delay in the construction activities, the said funds were temporarily invested in short term deposits.

Answer

(a) ***Non-Compliance of Laws and Regulations: As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statement", it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial***

statements. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statements.

Further, as per Section 128 of the Companies Act, 2013, a company has to maintain proper books of account on accrual basis and according to the double entry system of accounting.

Additionally, as per Section 43B of the Income Tax Act, 1961, there are certain expenses, which includes any sum payable by the assessee as an employer by way of contribution to any provident fund, which are allowed only on its actual payment.

In the instant case, even though accrual principles have been followed, disclosure of non-payment is necessary. The auditor should disclose the fact of non-payment of ₹ 10 lakhs in his report.

(b) As per the concept of Performance Audit, an auditor need to state in his report that whether the term loansis applied for the purpose for which the loan were obtained.

In the present case, the term loan obtained by LM Ltd. have not been put to use for construction activities and temporarily invested the same in short term deposit.

Here, the auditor should report the fact in his report that pending utilization of the term loan for construction of a factory, the funds were temporarily used for the purpose other than the purpose for which the loan was sanctioned.

Question 11

Write short notes on Emphasis of matter paragraph in Audit Reports.

Answer

Emphasis of matter paragraph in audit reports: An auditor's report can be modified for matters that do not affect the auditor's opinion. An "emphasis of matter" paragraph is such a type of modification in an audit report. In certain circumstances, such a paragraph is added to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such a paragraph does not affect the auditor's opinion.

SA 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", deals with additional communication in the auditor's report when the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements.

Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

(i) An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.

(ii) Early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date.

(iii) A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

Question 12

What are the features of a qualified Audit Report?

Answer

The features of a qualified report are-

(i) **Clarity:** The Auditor must express the nature of qualification, in a clear and unambiguous manner.

(ii) **Explanation:** Where the Auditor answers any of the statutory affirmations in the negative or with a qualification, his report shall state the reasons for such answer.

(iii) **Placement:** All qualifications should be contained in the Auditor's Report. When there are notes which are subject matter of a qualification, the same should preferably be annexed to the Auditors' Report. However a reference to the notes to Accounts in the Auditors' Report does not automatically become a qualification.

(iv) **Except for:** A quantified opinion should be expressed as "except for" for the effects of the matter to which qualification related. It would not be appropriate to use phrases such as "with the foregoing explanation" or "subject to" in the opinion paragraph as these are not sufficiently clear or forceful.

(v) **Quantification:** It is also necessary that the auditor should quantify, wherever possible, the effect of individual as well as the total effect of all qualifications on statement of profit and loss and/or state of affairs these qualifications on the financial statements in a clear and unambiguous manner. In circumstances where it is not possible to quantify the effect of the qualifications accurately the auditor may do so on the estimates made by the management after carrying out such audit tests as are possible and clearly indicate that the figures given are based on the estimates of the management.

(vi) **Nature of qualification:** Vague statements the effect of which on accounts cannot be ascertained like 'the trade receivables balances are subject to confirmation', 'no provision for taxation has been made in view of the loss during the year' etc., should be avoided.

(vii) **Violation of law:** Where the company has committed an irregularity resulting in a breach of law, the Auditor should bring the same to the notice of the shareholders by properly qualifying his report.

(viii) **Notes – Report Relationship** – Where notes of a qualificatory nature appear in the accounts, the Auditors should state all qualifications independently in their report so that the user can assess the significance of these qualifications.

(ix) **Draft Report:** The auditor may discuss matters of qualification with the management or those charged with governance of the company to acquire their views. It is not necessary that the Auditor should accept the management's view and modify his opinion. But it would enable the Auditor to accurately draft the qualifications in his Final Report.

Question 13

Discuss the various aspects to be considered by the Statutory Auditor before qualifying his report.

Answer

Aspects to be Considered before Qualifying the Audit Report: SA 705 "Modifications to the Opinion in the Independent Auditor's Report" specifies that auditor's report may need modification on account of certain matters which may or may not affect the auditor's opinion. There may be certain circumstances when an auditor may not be able to express an unqualified opinion because the effort of such circumstances in the auditor's judgment is, or may be material to the financial statements, for example, there is a limitation on the scope of the auditor's work or there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

The auditor shall express a qualified opinion when-

(i) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

(ii) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Further, while qualifying a report, it is important to appreciate as to which of the various items of statement of fact or statement of opinion require a qualification in respect of audit under the Companies Act, 2013. The auditor may also see whether the matters constituting the qualification involve a material contravention of any requirements of the Companies Act, 2013 which have a bearing on the accounts.

Finally, whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s), individually and in aggregate, on the financial statements should be mentioned in the auditor's report. A quantified opinion should be expressed as "except for" for the effects of the matter to which qualification related.

Question 14

Illustrate, as a statutory auditor, how would you give a report where all qualifications are not quantifiable.

Answer

An illustrative Format of Qualified Audit Report: SA 705 "Modifications to the Opinion in the Independent Auditor's Report" states that there may be circumstances when it is not practicable to quantify the effect of modifications made in the audit report accurately. In such cases, the auditor may do so on the basis of estimates made by the management after carrying out such audit tests as are possible and clearly indicate the fact that the figures are based on management estimates. Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

The following illustration of a qualification where quantification was not possible will explain the point:

"(2) No provision has been made in respect of product warranties outstanding at the year end. The amount of provision required in this behalf could not be ascertained."

In the above situation, the overall paragraph would appear as follows:

"We further report that, without considering item mentioned in paragraph (2) above, the effect of which could not be determined, had the observations made by us in paragraph (1) (not reproduced) and (2) above been considered, the profit for the year would have been ₹ 500.41 lacs (as against the reported figure of ₹ 596.07 lacs), reserves and surplus would have been ₹ 685.43 lacs (as against the reported figure of ₹ 781.09 lacs) and total fixed assets would have been ₹ 200.00 lacs (as against the reported figure of ₹ 229.05 lacs)"

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give.

Question 15

Bring out the significance of the following two illustrative paragraphs found in the statutory auditor's report in recent days.

(a) Opening Paragraph: "We have audited the attached Balance Sheet of ..... as at 31st March, 2xxx and also the Statement of Profit and Loss for the year ended on that date

annexed thereto. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements".

(b) Scope Paragraph: "We conducted our audit in accordance with the auditing standards generally accepted in India. Those standards require that we plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material statement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial presentation. We believe that our audit provides a reasonable basis for our opinion."

Answer

(a) Opening Paragraph: As per SA 700 "Forming an Opinion and Reporting on Financial Statements" the introductory paragraph in the auditor's report shall:

(1) Identify the entity whose financial statements have been audited;

(2) State that the financial statements have been audited;

(3) Identify the title of each statement that comprises the financial statements;

(4) Refer to the summary of significant accounting policies and other explanatory information; and

(5) Specify the date or period covered by each financial statement comprising the financial statements.

Further, the significance of 'opening paragraph' is to bring to the notice of the users of financial statements that preparation of the accounts is the responsibility of the management of the enterprise, whereas the responsibility of the auditor is to express an opinion on the said accounts based on audit carried out by him. The preparation of such statements requires management to make significant accounting estimates and judgements, as well as to determine the appropriate accounting principles and methods used in preparation of the said statements.

(b) Scope Paragraph: The significance of 'scope paragraph' is to inform the users about the practices and procedures followed in conduct of audit by the auditor. The auditor states in this paragraph that the audit was planned and performed in accordance with generally auditing standards generally accepted in India. The auditor also states that the audit provides a reasonable basis for his opinion. The significance of this paragraph lies in the fact that auditor wishes to convey to readers about the scope of audit by highlighting the nature and process of audit. The test check approach of audit adopted by the auditor in performing his work as also the significant aspect of evaluation of accounting principles and accounting estimates is also clarified. The basic objective of auditing that the auditor provides only "reasonable assurance" is emphasised in this paragraph. In a way, such a statement signifies inherent limitations of audit.

It is a description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit, that includes:

(1) A reference to Standards on Auditing and the law or regulation; and

(2) A description of an audit in accordance with those Standards.

Question 16

Write short notes on Certificate for Special Purpose vs. Audit Report.

Answer

Certificate for Special Purpose vs. Audit Report: A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. The term 'certificate' is, therefore, used where the auditor verifies the accuracy of facts. An auditor may thus, certify the circulation figures of a newspaper or the value of imports or exports of a company. An auditor's certificate represents that he has verified certain figures and is in a position to vouch safe their accuracy as per his examination of documents and books of account. A report, on the other hand, is a formal statement usually made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill. The 'report' involves expression of opinion which may differ from one professional to another. There is no question of exactitude in case of a report since the information contained therein is based on estimates and involves judgement element.

Question 17

During the course of audit of ABC Ltd. it is noticed that out of ₹ 12 lakhs of provident fund contribution accounted in the books, only ₹ 2 lakhs has been remitted to the authorities during the year. On enquiry the Chief Accountant informed that due to financial problems they have not remitted but will remit the same as and when the position improves. As a Statutory Auditor, how would you deal?

Answer

Non-Compliance of Laws and Regulations: As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statement", it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial

statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statements.

Further, as per Section 128 of the Companies Act, 2013, a company has to maintain proper books of account on accrual basis and according to the double entry system of accounting.

Additionally, as per Section 43B of the Income Tax Act, 1961, there are certain expenses, which includes any sum payable by the assessee as an employer by way of contribution to any provident fund, which are allowed only on its actual payment.

In the instant case, out of ₹ 12 lakhs of provident fund contribution accounted in the books, only ₹ 2 lakhs has been remitted to the authorities due to financial problems during the year. Hence, even though accrual principles have been followed, disclosure of non-payment is necessary. The auditor should disclose the fact of non-payment of ₹ 10 lakhs in his report.

8

Audit Report

Question 1

Beta Limited, is a company registered with SEBI, having five subsidiaries.

M/s XYZ, Chartered Accountants, have been appointed as Statutory Auditors for the audit of the Consolidated Financial Statements for the year ending March 31, 2013. Out of five subsidiaries, the audit of one subsidiary was conducted by another auditor, M/s Badnam and Company, Chartered Accountants. The "Opinion" para of audit report furnished by M/s XYZ Chartered Accountants is given below:

Opinion

In our opinion and to the best of our information and according to the explanations given to us the consolidated financial statements give a true and fair view, except the financial statement of one subsidiary whose accounts were audited by M/s Badnam and Company, Chartered Accountants and about the same we are not in a position to express our opinion as the audit has not been performed by us :

(i) in the case of the consolidated Balance Sheet, of the state of affairs of the Company as at March 31, 2013.

(ii) in the case of the consolidated Profit and Loss Account, of the profit/loss for the year ended on that date.

Do you find any deficiencies in the opinion para? If yes, you are required to give your suggestions and redraft the opinion para. (5 Marks, November, 2013)

Answer

Opinion Para and Other Matter Para: Yes, the opinion para contains the following deficiencies-

1. Out of five subsidiaries, the audit of one subsidiary was conducted by another auditor, M/s Badnam and Company which would be reported in other matter para.
2. After point no. (ii) in the opinion para, point no. (iii) would appear as under-

   "in the case of the consolidated Cash Flow Statement, of the cash flows for the year ended on that date."

The redrafted opinion para and other matter para are given hereunder as per SA 706 on Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report-

Opinion Para

In our opinion and to the best of our information and according to the explanations given to us and based on the consideration of the reports of the other auditors on the financial statements of the subsidiaries as noted below, the consolidated financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

(i) in the case of the consolidated Balance Sheet, of the state of affairs of the Company as at March 31, 2013;

(ii) in the case of the consolidated Profit and Loss Account, of the profit/ loss for the year ended on that date; and

(iii) in the case of the consolidated Cash Flow Statement, of the cash flows for the year ended on that date.

Other Matter Para

We did not audit the financial statements of one subsidiary, whose financial statements reflect total assets (net) of ₹ XXXX as at March 31, 2013, total revenues of ₹ XXXX and net cash outflows amounting to ₹ XXXX for the year then ended. These financial statements have been audited by other auditors M/s Badnam and Company, Chartered Accountants whose reports have been furnished to us by the Management, and our opinion is based solely on the reports of the other auditors. Our opinion is not qualified in respect of this matter.

Question 2

X Ltd closed its manufacturing operations and sold all its manufacturing fixed assets during the financial year ended 31st March, 2013. However it intends continue its operations as a trading company. In respect of other fixed assets, the company carried out a physical verification as at the end of 31st March, 2013 and found a material discrepancy to the tune of ₹ 1 lac, which was written off and is disclosed separately in the profit and loss account. Kindly incorporate the above in your audit report. (4 Marks, November, 2013)

Answer

Disclosure in Audit Report: As per SA 570 "Going Concern", when the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements-

(i) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(ii) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

In the given case, X Ltd. has sold out its manufacturing fixed assets during the year. However, it intends to continue its operations as a trading company. Therefore, selling of manufacturing fixed assets does not affect the going concern assumption of the company. Additionally, while carrying out physical verification of fixed assets, a material discrepancy to the tune of ` 1 lac

was found, which was written off and disclosed separately in the profit and loss account. Hence, this fact needs to be disclosed in the Audit Report as follows:

Para in the Audit Report-

We have made our viewpoint from the facts of the case and on the basis of guidance drawn from AS 1. We report as under-

As per Accounting Standard (AS) 1, "Disclosure of Accounting Policies", "the enterprise is normally viewed as a going concern that is as continuing its operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations." Although the company has disposed off its manufacturing fixed assets during the financial year ending on 31-03-2013, it is still a going concern in the form of a trading company. We also report that on physical verification of other fixed assets, a material discrepancy to the tune of ₹ 1 Lac was noticed and that the same has been properly dealt with in the books of account.

Question 3

(a) H Private Ltd had taken overdrafts from two banks with a limit of 10 lacs each against the security of fixed deposit it had with those banks and an unsecured overdraft from a financial institution of 9 lacs. The said loans were outstanding as at 31st March 13. The paid up capital and reserves of the company as at that date was 40 lacs and its turnover during the financial year ended on 31st March 13 was 3 crores. The management of the company is of the opinion that CARO 03 is not applicable to it because turnover and paid up capital were within the limits prescribed and loans taken against the fixed deposits cannot be considered. The company further contended that loan limit is to be reckoned per bank or financial institution and not cumulatively. Comment. (4 Marks, May, 2013)

(b) XYZ Ltd has significant operations in a foreign country. Due to civil and political unrest in that country physical verification of inventory and fixed assets could not carried out and you are not in a position to obtain audit evidence through other audit procedures also. The value of fixed assets and inventory forms part of 80% of the asset value of the company. As the auditor of XYZ Ltd what factors do you consider in your reporting responsibility. Also draft a suitable report that will be incorporated in the main audit report (Reporting under CARO 03 need not be considered). (8 Marks, May, 2013)

(c) R Ltd. As at 31st March, 2013 defaulted in the repayment of interest and principal due to a financial institution. The due date was 28th February, 2013. However, the defaulted amount was paid on 5th April, 2013. The company's management is of the opinion that since the default is set right before the audit completion these need not be reported in CARO 03. Comment and draft a suitable report. (4 Marks, May, 2013)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 4

Under the applicable Standards on Auditing, in what circumstances does the report of the as a statutory auditor require modifications? What are the types of modifications possible to the said report? (8 Marks, November, 2012)

Answer

Circumstances for modifications in Audit Report: As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", the auditor shall modify the opinion in the auditor's report in the following circumstances-

(i) If the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

(ii) If the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

As per SA 700, "Forming an Opinion and Reporting on Financial Statements", if financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with SA 705.

Types of Modification to the Auditor's Opinion: As per SA 705, "Modification to the Opinion in the Independent Auditor's Report", modified opinion may be defined as a qualified opinion, an adverse opinion or a disclaimer of opinion.

Types of modifications possible to the said report are below-mentioned-

(i) **Qualified Opinion**: The auditor shall express a qualified opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

(ii) **Adverse Opinion**: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

(iii) **Disclaimer of Opinion**: The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

Question 5

Under CARO, 2003, how, as a statutory auditor would you comment on the following:

(a) X Pvt. Ltd. is a subsidiary of a listed entity incorporated outside India. The management of the company believes that since, X Pvt. Ltd. is a Private Company and satisfies all

condition under the Companies (Auditor's Report) Order, 2003, reporting under CARO is not applicable.

(b) A term loan was obtained from a bank for ₹ 50 lakhs for the purpose of purchase of assets for Research & Development (R & D). Out of these funds, a vehicle was purchased for the use of the concerned director who was in charge of the R & D activities. (8 Marks, November, 2012)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 6

"Non-compliance of Section 58 AA inserted by the Companies (Amendment) Act, 2000 would occur where the company fails to intimate the Company Law Board, any default in repayment of deposits made by small depositors or part thereof or any interest there on."

Discuss this statement and state reporting requirements under the Companies (Auditor's Report) Order, 2003 for non-compliance of Section 58 AA of the Companies Act, 1956.

(8 Marks, May, 2012)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 7

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

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

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

As an auditor, how would you bring this fact to the members? (5 Marks, November, 2011)

Answer

Non-Compliance of Laws and Regulations: As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statement", it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statements.

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 "Provisions, Contingent Liabilities and Contingent Assets", partly to the extent the company considers 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 the members by reporting.

Additionally, the demand notice has been received for Customs duty of ₹ 85 lakhs and is outstanding on the closure of financial year, for which no action has been taken by the management. Therefore, it should also be brought to notice of the members by reporting.

Question 8

ABC Private Ltd. has granted loan of ₹ 20 crores to XYZ Ltd. a sister concern and it remains outstanding at the year end. How would you report the fact? (4 Marks, November, 2011)

Answer

Reporting of "Loan to Related Party": As per AS 18 "Related Party Disclosures", related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged. According to this AS, in the case of related party transactions, the reporting enterprise should disclose the following-

(i) the name of the transacting related party;

(ii) a description of the relationship between the parties;

(iii) a description of the nature of transactions;

(iv) volume of the transactions either as an amount or as an appropriate proportion;

(v) any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and

(vii) amounts written off or written back in the period in respect of debts due from or to related parties."

In the instant case, ABC Pvt. Ltd. has granted a loan of ₹ 20 crores to XYZ Ltd., a sister concern, and it remains outstanding at the year end. The case is squarely covered by AS 18.

Further, SA 550 on "Related Parties", also prescribes the auditor's responsibilities and audit procedures regarding related party transactions. Auditor should insist to make proper disclosure as per the AS and if management refuses, the auditor shall have to modify his report.

Question 9

(a) OK Ltd. has taken a term loan from a nationalized bank in 2006 for ₹ 200 lakhs repayable in five equal instalments of ₹ 40 lakhs from 31st March, 2007 onwards. It had repaid the loans due in 2007 & 2008, but defaulted in 2009, 2010 & 2011. As the auditor of OK Ltd. what is your responsibility assuming that company has sought reschedulement of loan? (4 Marks, May 2011)

(b) Big and Small Ltd. received a show cause notice from central excise department intending to levy a demand of ₹ 25 lakhs in December 2010. The company replied to the above notice in January 2011 contending that it is not liable for the levy. No further action was initiated by the central excise department upto the finalization of the audit for the year ended on 31st March, 2011. As the auditor of the company, what is your role in this? (4 Marks, May 2011)

(c) Director of T Ltd. draws an advance of US$ 200 per day in connection with the foreign trip undertaken on behalf of the company. On his return he files a declaration stating that entire advance was expended without any supporting or evidence. T Ltd. books the entire expenses on the basis of such declaration. As the auditor of T Ltd. how do you deal with this? (8 Marks, May 2011)

Answer

(a) As per the concept of Propriety and Performance Audit, the auditors of a company has to report if the Company has defaulted in repayment of its dues to financial institutions or bank or debentures holders and if yes the period and amount of default to be reported.

In this case, OK Ltd. has defaulted in repayment of dues for three years. Application for rescheduling will not change the default position. Hence the auditor has to report in his audit report that the Company has defaulted in its repayment of dues to the bank to the extent of ₹ 120 lakhs.

(b) Non-Compliance of Laws and Regulations: As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statement", it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statements.

In the present case issuance of show cause notice by Excise Department does not tantamount to demand payable by the Company. In so far as the Company has replied to the notice and no further correspondence was received from the Department, it has to be construed that there is no demand. Therefore, the auditor needs not to report on this.

(c) Audit Evidence: SA 500 "Audit Evidence" states that an auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base his option.

Section 143(1)(e) the Companies Act, 2013 requires an auditor to enquire whether personal expenses have been charged to revenue account.

In the context of the facts of case, ascertain whether the payment made by the company for the foreign trip form an "allowance" or "reimbursement". An allowance is a fixed sum of money allowed or the basis of specified criteria. No evidence supporting the expenditure is required for payment of allowance to the director. On the other hand, if the payment is reimbursement should be against actual expenditure.

The director concerned should provide proof of expenditure. Since the director has given only a declaration, the auditor should ascertain other relevant facts as to whether the advance paid is pursuant to the policy of the company which is based on approximate estimation of the expenditure normally incurred by a person of the status of a director and the same is applicable to persons of a similar status within the company. If the auditor considers the advance taken is reasonable then the declaration can be considered adequate, otherwise he may have to call for additional documentary evidences.

Question 10

(a) Mr. X, Director of ABC Ltd. made a purchase contract for ₹ 10,00,000 with the company. Comment.

(b) PQR Ltd., a listed company and having an average annual turnover of more than ₹ 5 crores has no Internal Audit System. Give your views. (5 Marks each, November, 2010)

Answer

(a) Responsibility of Auditor in relation to the Companies Act 2013: As per Section 188 of the Companies Act, 2013, no company shall enter into any contract or arrangement with a related party to sale, purchase or supply of any goods or materials, except with the consent of the Board of Directors given by a resolution at a Board Meeting. Further, it is provided that no contract or arrangement, in the case of a company having specified paid-up share capital, or transactions exceeding prescribed sum, shall be entered into except with the prior approval of the company by a special resolution.

The contracts or arrangements mentioned above are those for which the register(s) are maintained under section 189 of the Companies Act, 2013 .The scope of the auditor's inquiry under this clause is restricted to such transactions referred to in sections 184 and 188 of the Act.

The auditor should, while reporting, in the first instance, determine whether the aggregate value of all the transactions entered into with any of the companies/firms/parties covered in the register maintained under section 189 of the Act exceed the value of rupees five lakhs in the year. If so, the auditor has to examine whether each of the transactions entered into with such a company/firm/party have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time. Further, the auditor while reporting should clearly bring out the reasons as to why no adverse comment was considered necessary.

The contracts referred to in section 188 are for sale, purchase or supply of any goods, materials or services and contract of underwriting the subscription of any securities or derivatives of the company between a Company and its director or, its relative, a firm in which the director or relative is a partner, any other partner in such a firm or a private company of which the director is a member or director. The auditor will have to obtain the list of such parties which are covered by section 188 mentioned above.

Hence, the auditor should ensure that all the above mentioned provisions have been compiled with.

(b) Internal Audit System: As per section 138 of the Companies Act, 2013, the following class of companies (prescribed in rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely-

(1) every listed company;

(2) every unlisted public company having-

(i) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(ii) turnover of two hundred crore rupees or more during the preceding financial year; or

(iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(3) every private company having-

(i) turnover of two hundred crore rupees or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

In the instant case, PQR Ltd is a listed company and having an average annual turnover of more than ₹ 5 crores. As the company is a listed company, the provisions related to internal audit shall be applicable to the company. The turnover limit given has no relevance here. Therefore, the auditor will have to mention in his report the fact of not having such internal audit system by the Company.

Question 11

A Private Limited reports the following position as on 31st March, 2010 :

Paid up capital	*30 lacs*
Revaluation reserve	*10 lacs*
Capital reserve	*11 lacs*
P&L A/c [Dr. Balance]	*2 lacs*

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

(5 Marks, May, 2010)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 12

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

(a) PQR Ltd. has not deposited Provident Fund contribution of ₹ 10 lakhs with the authorities till the year-end.

(b) LM Ltd. had obtained a Term Loan of ₹ 300 lakhs from a bank for the construction of a factory. Since there was a delay in the construction activities, the said funds were temporarily invested in short term deposits. (4 Marks each, May 2008)

Answer

(a) Non-Compliance of Laws and Regulations: As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statement", it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statements.

Further, as per Section 128 of the Companies Act, 2013, a company has to maintain proper books of account on accrual basis and according to the double entry system of accounting.

Additionally, as per Section 43B of the Income Tax Act, 1961, there are certain expenses, which includes any sum payable by the assessee as an employer by way of contribution to any provident fund, which are allowed only on its actual payment.

In the instant case, even though accrual principles have been followed, disclosure of non-payment is necessary. The auditor should disclose the fact of non-payment of ₹ 10 lakhs in his report.

(b) As per the concept of Performance Audit, an auditor need to state in his report that whether the term loansis applied for the purpose for which the loan were obtained.

In the present case, the term loan obtained by LM Ltd. have not been put to use for construction activities and temporarily invested the same in short term deposit.

Here, the auditor should report the fact in his report that pending utilization of the term loan for construction of a factory, the funds were temporarily used for the purpose other than the purpose for which the loan was sanctioned.

Question 13

Write short notes on Emphasis of matter paragraph in Audit Reports. *(4 Marks, May 2008)*

Answer

Emphasis of matter paragraph in audit reports: An auditor's report can be modified for matters that do not affect the auditor's opinion. An "emphasis of matter" paragraph is such a type of modification in an audit report. In certain circumstances, such a paragraph is added to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such a paragraph does not affect the auditor's opinion.

SA 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", deals with additional communication in the auditor's report when the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements.

Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

(i) An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.

(ii) Early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date.

(iii) A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

Question 14

What are the features of a qualified Audit Report? *(8 Marks, November 2007)*

Answer

The features of a qualified report are-

(i) *Clarity:* The Auditor must express the nature of qualification, in a clear and unambiguous manner.

(ii) *Explanation:* Where the Auditor answers any of the statutory affirmations in the negative or with a qualification, his report shall state the reasons for such answer.

(iii) *Placement:* All qualifications should be contained in the Auditor's Report. When there are notes which are subject matter of a qualification, the same should preferably be annexed to the Auditors' Report. However a reference to the notes to Accounts in the Auditors' Report does not automatically become a qualification.

(iv) *Except for:* A quantified opinion should be expressed as "except for" for the effects of the matter to which qualification related. It would not be appropriate to use phrases such as "with the foregoing explanation" or "subject to" in the opinion paragraph as these are not sufficiently clear or forceful.

(v) *Quantification:* It is also necessary that the auditor should quantify, wherever possible, the effect of individual as well as the total effect of all qualifications on statement of profit and loss and/or state of affairs these qualifications on the financial statements in a clear and unambiguous manner. In circumstances where it is not possible to quantify the effect of the qualifications accurately the auditor may do so on the estimates made by the management after carrying out such audit tests as are possible and clearly indicate that the figures given are based on the estimates of the management.

(vi) *Nature of qualification:* Vague statements the effect of which on accounts cannot be ascertained like 'the trade receivables balances are subject to confirmation', 'no provision for taxation has been made in view of the loss during the year' etc., should be avoided.

(vii) *Violation of law:* Where the company has committed an irregularity resulting in a breach of law, the Auditor should bring the same to the notice of the shareholders by properly qualifying his report.

(viii) *Notes – Report Relationship* – Where notes of a qualificatory nature appear in the accounts, the Auditors should state all qualifications independently in their report so that the user can assess the significance of these qualifications.

(ix) *Draft Report:* The auditor may discuss matters of qualification with the management or those charged with governance of the company to acquire their views. It is not necessary that the Auditor should accept the management's view and modify his opinion. But it would enable the Auditor to accurately draft the qualifications in his Final Report.

Question 15

T Pvt. Ltd.'s paid up Capital & Reserves are less than ₹ 50 lakhs and it has no outstanding loan exceeding ₹ 25 lakhs from any bank or financial institution. Its sales are ₹ 6 crores before deducting Trade discount ₹ 10 lakhs and Sales returns ₹95 lakhs. The services rendered by the company amounted to ₹ 10 lakhs. The company contends that reporting under Companies Auditor's Reports Order (CARO) is not applicable. Discuss. (4 Marks, November 2007)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 16

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

(a) L Private Ltd., which has outstanding loan of ₹ 50 lakhs from Financial Institution defaulted in repayment thereof to the extent of 50%. The company holds that it being a private limited company, the Companies Auditors Report Order (CARO) is not applicable. (4 Marks, May 2007)

(b) ABC Limited to whom CARO is applicable made a public issue of 7% debentures of ₹ 3 crores, redeemable after 5 years and used the proceeds of issue for payment of Sundry creditors and other Current liabilities to the tune of 3 crores.(4 Marks, May 2007)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 17

Draft audit report u/s 227(3)(f) of the Companies Act, 1956 on the following three situations in respect XYZ Ltd. as on 31.3.2006:

(a) Where all directors have given written representations that they have not defaulted u/s 274(1)(g) of the Companies Act, 1956. (2 Marks, November, 2006)

(b) Where one of the directors, Mr. Flexible has failed to produce written representation that he has not defaulted u/s 274(1)(g) of the Companies Act, 1956. (3 Marks, November, 2006)

(c) Where on the basis of written representations received from the directors it is noticed that one of the directors, Mr. Rigid has defaulted in terms of Section 274(1)(g) of the Companies Act, 1956. (3 Marks, November, 2006)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 18

Answer the following:

(a) Discuss the various aspects to be considered by the Statutory Auditor before qualifying his report. (8 Marks, May, 2006)

(b) As a Statutory Auditor, how would you report on the following under CARO:

(i) O Pvt. Ltd. Is a dealer in Shares and Securities. (4 Marks, May, 2006)

(ii) ABC Pvt. Ltd. Is an Manufacturer of jewellery. A senior employee of the Company informed you that the Company does not properly disclose the purity of gold used on the jewellery. (4 Marks, May, 2006)

Answer

(a) Aspects to be Considered before Qualifying the Audit Report: SA 705 "Modifications to the Opinion in the Independent Auditor's Report" specifies that auditor's report may need modification on account of certain matters which may or may not affect the auditor's opinion. There may be certain circumstances when an auditor may not be able to express an unqualified opinion because the effort of such circumstances in the auditor's judgment is, or may be material to the financial statements, for example, there is a limitation on the scope of the auditor's work or there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

The auditor shall express a qualified opinion when-

(i) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

(ii) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Further, while qualifying a report, it is important to appreciate as to which of the various items of statement of fact or statement of opinion require a qualification in respect of audit under the Companies Act, 2013. The auditor may also see whether the matters constituting the qualification involve a material contravention of any requirements of the Companies Act, 2013 which have a bearing on the accounts.

Finally, whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s), individually and in aggregate, on the financial statements should be mentioned in the auditor's report. A quantified opinion should be expressed as "except for" for the effects of the matter to which qualification related.

(b) This question is redundant in view of the provisions of the Companies Act, 2013.

Question 19

Answer the following:

(a) Illustrate, as a statutory auditor, how would you give a report where all qualifications are not quantifiable. (4 Marks, November, 2005)

(b) Under CARO, 2003 how, as a statutory auditor would you comment on the following:

(i) Fixed assets comprising 1/3rd of the total assets have been disposed off during the year. (4 Marks, November, 2005)

(ii) A Term Loan was obtained from a bank for ₹ 75 lakhs for acquiring R&D equipment, out of which ₹ 12 lakhs was used to buy a car for use of the concerned director, who was overlooking the R&D activities. (4 Marks, November, 2005)

Answer

(a) An illustrative Format of Qualified Audit Report: SA 705 "Modifications to the Opinion in the Independent Auditor's Report" states that there may be circumstances when it is not practicable to quantify the effect of modifications made in the audit report accurately. In such cases, the auditor may do so on the basis of estimates made by the management after carrying out such audit tests as are possible and clearly indicate the fact that the figures are based on management estimates. Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

The following illustration of a qualification where quantification was not possible will explain the point:

"(2) No provision has been made in respect of product warranties outstanding at the year end. The amount of provision required in this behalf could not be ascertained."

In the above situation, the overall paragraph would appear as follows:

"We further report that, without considering item mentioned in paragraph (2) above, the effect of which could not be determined, had the observations made by us in paragraph (1) (not reproduced) and (2) above been considered, the profit for the year would have been ₹ 500.41 lacs (as against the reported figure of ₹ 596.07 lacs), reserves and surplus would have been ₹ 685.43 lacs (as against the reported figure of ₹ 781.09 lacs) and total fixed assets would have been ₹ 200.00 lacs (as against the reported figure of ₹ 229.05 lacs)"

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give.

(b) This question is redundant in view of the provisions of the Companies Act, 2013.

Question 20

(a) A Pvt. Ltd. is incorporated on 1st July, 2004. During the year ended 31st March, 2005, it had issued shares (fully paid up) of ₹ 40 lakhs, had borrowed ₹ 7.5 lakhs each from 2 financial institutions and its turnover (Net of excise ₹ 50 lakhs which is credited to a separate account) is ₹ 475 lakhs. Will Companies Auditors Report Order, 2003 (CARO) be applicable to A Pvt. Ltd.? (4 Marks, May, 2005)

(b) As the statutory auditor of B Ltd. to whom CARO, 2003 is applicable, how would you report in the following situations?

(i) The company has stood guarantee to its sister concern, whose financial condition was not healthy for a sum of ₹ 20 lakhs borrowed from a bank.

(ii) Physical verification of only 50% (in value) of items of inventory has been conducted by the company. The balance 50% will be conducted in next year due to lack of time and resources.

(iii) Accumulated losses of the company are 50.9% of its net worth and it is incurring continuous cash losses since last 2 years. (4 Marks each, May, 2005)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 21

(a) Enumerate the 'Basic Elements of Audit Report' as enshrined in AAS-28.

(8 Marks, November, 2004)

(b) Bring out the significance of the following two illustrative paragraphs found in the statutory auditor's report in recent days.

(i) *Opening Paragraph:* "We have audited the attached Balance Sheet of …….. as at 31st March, 2xxx and also the Profit and Loss Account for the year ended on that date annexed thereto. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements". *(4 Marks, November, 2004)*

(ii) *Scope Paragraph: "We conducted our audit in accordance with the auditing standards generally accepted in India. Those standards require that we plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material statement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial presentation. We believe that our audit provides a reasonable basis for our opinion."*

(4 Marks, November, 2004)

Answer

(a) This question is redundant in view of the latest Engagement and Quality Control Standards.

(b) (i) Opening Paragraph: As per SA 700 "Forming an Opinion and Reporting on Financial Statements" the introductory paragraph in the auditor's report shall:

(1) Identify the entity whose financial statements have been audited;

(2) State that the financial statements have been audited;

(3) Identify the title of each statement that comprises the financial statements;

(4) Refer to the summary of significant accounting policies and other explanatory information; and

(5) Specify the date or period covered by each financial statement comprising the financial statements.

Further, the significance of 'opening paragraph' is to bring to the notice of the users of financial statements that preparation of the accounts is the responsibility of the management of the enterprise, whereas the responsibility of the auditor is to express an opinion on the said accounts based on audit carried out by him. The preparation of such statements requires management to make significant accounting estimates and judgements, as well as to determine the appropriate accounting principles and methods used in preparation of the said statements.

(ii) Scope Paragraph: The significance of 'scope paragraph' is to inform the users about the practices and procedures followed in conduct of audit by the auditor. The auditor states in this paragraph that the audit was planned and performed in accordance with generally auditing standards generally accepted in India. The auditor also states that the audit provides a reasonable basis for his opinion. The significance of this paragraph lies in the fact that auditor wishes to convey to readers about the scope of audit by highlighting the nature and process of audit. The test check approach of audit adopted by the auditor in performing his work as also the significant aspect of evaluation of accounting principles and accounting estimates is also clarified. The basic objective of auditing that the auditor provides only "reasonable assurance" is emphasised in this paragraph. In a way, such a statement signifies inherent limitations of audit.

It is a description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit, that includes:

(1) A reference to Standards on Auditing and the law or regulation; and

(2) A description of an audit in accordance with those Standards.

Question 22

Write short notes on Certificate for Special Purpose vs. Audit Report.

(4 Marks, November, 2004)

Answer

Certificate for Special Purpose vs. Audit Report: A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. The term 'certificate' is, therefore, used where the auditor verifies the accuracy of facts. An auditor may thus, certify the circulation figures of a newspaper or the value of imports or exports of a company. An auditor's certificate represents that he has verified certain figures and is in a position to vouch safe their accuracy as per his examination of documents and books of account. A report, on the other hand, is a formal statement usually made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill. The 'report' involves expression of opinion which may differ from one professional to another. There is no question of exactitude in case of a report since the information contained therein is based on estimates and involves judgement element.

Question 23

During the course of audit of ABC Ltd. it is noticed that out of ₹ 12 lakhs of provident fund contribution accounted in the books, only ₹ 2 lakhs has been remitted to the authorities during the year. On enquiry the Chief Accountant informed that due to financial problems they have not remitted but will remit the same as and when the position improves. As a Statutory Auditor, how would you deal? *(4 Marks, May, 2004)*

Answer

Non-Compliance of Laws and Regulations: As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statement", it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statements.

Further, as per Section 128 of the Companies Act, 2013, a company has to maintain proper books of account on accrual basis and according to the double entry system of accounting.

Additionally, as per Section 43B of the Income Tax Act, 1961, there are certain expenses, which includes any sum payable by the assessee as an employer by way of contribution to any provident fund, which are allowed only on its actual payment.

In the instant case, out of ₹ 12 lakhs of provident fund contribution accounted in the books, only ₹ 2 lakhs has been remitted to the authorities due to financial problems during the year. Hence, even though accrual principles have been followed, disclosure of non-payment is necessary. The auditor should disclose the fact of non-payment of ₹ 10 lakhs in his report.

Question 24

As Chartered Accountant you are required to give your reports on various financial statements under Companies Act, 1956 which are as under:

(a) Report to the shareholders under Section 227;

(b) Report to be set out in prospectus under Section 60(3);

(c) Report to be given to the Central Government as special auditor under Section 233 A;

(d) Report to be given on voluntary winding up under Section 488(1).

Explain the significance of each of these reports and your functional approach very briefly.

(8 Marks, May, 2004)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

9

Audit Committee and Corporate Governance

Question 1

Explain the Constitution of Audit Committee under Section 177 of the Companies Act, 2013.

Answer

Constitution of Audit Committee: As per the section 177 of the Companies Act, 2013, every listed company and the following classes of companies shall constitute an Audit Committee -

(i) all public companies with a paid up capital of ten crore rupees or more;

(ii) all public companies having turnover of one hundred crore rupees or more;

(iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

Explanation- The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purposes of this rule.

Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

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, 2013 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.

Question 2

Dishonest Limited, a company incorporated in India has six members in its Audit Committee. Due to recessionary conditions in India the revenue of the company is going down and there is slow down in other activities of the company. Therefore, it was expected that there would not be significant work for members of the Audit Committee. Considering the overall recession in the company and the economy, the members of the Committee decided unanimously to meet once in a year only on March 31, 2014. They reviewed monthly information system of the Company and found no errors. As an auditor of Dishonest Limited would you consider the decision taken by the Audit Committee is in line with the Clause 49 of the (SEBI) Listing Agreement?

Answer

One of the following additional requirement as stipulated under clause 49 on which Section 177 of the Companies Act, 2013 (relating to audit committee) is silent is – The Audit Committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.

Besides, there is a mandatory review requirement and to review only monthly information system is not sufficient. Here the audit committee members reviewed only monthly information system of the company and the same is not sufficient as per clause 49.

The Audit Committee shall mandatorily review the following information as per Clause 49:

(i) Management discussion and analysis of financial condition and results of operations;

(ii) Statement of significant related party transactions (as defined by the Audit Committee), submitted by management;

(iii) Management letters / letters of internal control weaknesses issued by the statutory auditors;

(iv) Internal audit reports relating to internal control weaknesses; and

(v) The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.

Applying the above, the decision taken by the audit committee is not in line with the clause 49 of the (SEBI) Listing Agreement.

Question 3

Write short notes on Content of Management Discussion and Analysis.

Answer

Content of Management Discussion and Analysis:

1. As part of the directors' report or as an addition thereto, a Management Discussion

and Analysis report should form part of the Annual Report to the shareholders. This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company's competitive position:

(i) Industry structure and developments.

(ii) Opportunities and Threats.

(iii) Segment–wise or product-wise performance.

(iv) Outlook

(v) Risks and concerns.

(vi) Internal control systems and their adequacy.

(vii) Discussion on financial performance with respect to operational performance.

(viii) Material developments in Human Resources/Industrial Relations front, including number of people employed.

2. Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.).

Explanation: For this purpose, the term "senior management" shall mean personnel of the company who are members of its core management team excluding the Board of Directors). This would also include all members of management one level below the executive directors including all functional heads.

3. The Code of Conduct for the Board of Directors and the senior management shall be disclosed on the website of the company.

Question 4

State the "Mandatory Review" areas of the audit committee.

Answer

Mandatory Review Areas of the Audit Committee: The Audit Committee shall mandatorily review the following information as per Clause 49 of the Listing Agreement:

(i) Management discussion and analysis of financial condition and results of operations;

(ii) Statement of significant related party transactions (as defined by the Audit Committee), submitted by management;

(iii) Management letters / letters of internal control weaknesses issued by the statutory auditors;

(iv) Internal audit reports relating to internal control weaknesses; and

(v) The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.

Question 5

State the main features of the Qualified and Independent Audit Committee set up under clause 49 of the listing agreement.

Answer

The main features of a qualified and independent audit committee to be set up under clause 49 of listing agreement are as follows:

1. The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors;

2. All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise;

Explanation (i): The term "financially literate" means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

Explanation (ii): A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

3. The Chairman of the Audit Committee shall be an independent director;

4. The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;

5. The Audit Committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee;

6. The Company Secretary shall act as the secretary to the committee.

Question 6

Elaborate under Clause 49 of the Listing Agreement, who is an Independent Director.

Answer

Clause 49 of the listing agreement on Independent Director: As per Clause 49 of the listing agreement, an Independent Director shall mean a non-executive director, other than a nominee director of the company:

1. *who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience;*
2. *(i) who is or was not a promoter of the company or its holding, subsidiary or associate company;*

   (ii) who is not related to promoters or directors in the company, its holding, subsidiary or associate company;
3. *apart from receiving director's remuneration, has or had no pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year;*
4. *none of whose relatives has or had pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or their promoters, or directors, amounting to two per cent. or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year;*
5. *who, neither himself nor any of his relatives —*

   (i) holds or has held the position of a key managerial personnel or is or has been employee of the company or its holding, subsidiary or associate company in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed;

   (ii) is or has been an employee or proprietor or a partner, in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, of —

      (A) a firm of auditors or company secretaries in practice or cost auditors of the company or its holding, subsidiary or associate company; or

      (B) any legal or a consulting firm that has or had any transaction with the company, its holding, subsidiary or associate company amounting to ten per cent or more of the gross turnover of such firm;

   (iii) holds together with his relatives two per cent or more of the total voting power of the company; or

   (iv) is a Chief Executive or director, by whatever name called, of any non-profit organisation that receives twenty-five per cent or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company or that holds two per cent or more of the total voting power of the company;

   (v) is a material supplier, service provider or customer or a lessor or lessee of the company;
6. *Who is not less than 21 years of age.*

Question 7

Write short notes on Corporate Governance.

Answer

Corporate Governance: Corporate governance is the system by which companies are directed and controlled by the management in the best interest of the shareholders and others ensuring greater transparency and better and timely financial reporting. The Board of Directors are responsible for governance of their companies. A number of reports and codes of corporate governance have been published internationally.

The Securities and Exchange Board of India (SEBI) had set up a Committee under the Chairmanship of Shri Kumar Manglam Birla to formulate the code of corporate governance. The Securities and Exchange Board of India (SEBI) with the objective to align its provisions to the recently notified provisions of the Companies Act, 2013, ('the Act') has specifically reviewed clause 49 of the Listing Agreement, to adopt leading industry practices on corporate governance and to make the corporate governance framework more effective. The revised clause 49 on corporate governance shall be applicable to all listed companies with effect from 1 October 2014, except for the clause relating to the constitution of a Risk Management Committee which shall apply to the top 100 listed companies by market capitalisation, as at the end of the immediate previous financial year.

Various clauses deal with composition of board, setting-up of audit committee including scope thereof, remuneration of directors, meetings of Board, contents of management discussions and analysis report, etc.

Clause 49 also prescribes that there shall be a separate section on Corporate Governance in the annual reports of company, with a detailed compliance report on Corporate Governance. Non compliance of any mandatory requirement i.e. which is part of the listing agreement with reasons there of and the extent to which the non-mandatory requirements have been adopted, should be specifically highlighted. Further, the entity is required to obtain a certificate from the statutory auditor of the entity as regards compliance of conditions of corporate governance as stipulated in that clause.

A monitoring cell set up by SEBI, will assess compliance by companies with the requirements of clause 49 and report noncompliances to SEBI within 60 days from the end of each quarter. This shows the strong intent of SEBI to not only bring in regulations, but also put in place a monitoring mechanism.

Note: SEBI has revised Clause 49 vide its Circular dated April 17, 2014 with effect from 1 October 2014.

9

Audit Committee and Corporate Governance

Question 1

Dishonest Limited, a company incorporated in India has six members in its Audit Committee. Due to recessionary conditions in India the revenue of the company is going down and there is slow down in other activities of the company. Therefore, it was expected that there would not be significant work for members of the Audit Committee. Considering the overall recession in the company and the economy, the members of the Committee decided unanimously to meet once in a year only on March 31, 2013. They reviewed monthly information system of the Company and found no errors. As an auditor of Dishonest Limited would you consider the decision taken by the Audit Committee is in line with the Clause 49 of the (SEBI) Listing Agreement? *(4 Marks, November, 2013)*

Answer

One of the following additional requirement as stipulated under clause 49 on which Section 177 of the Companies Act, 2013 (relating to audit committee) is silent is – The Audit Committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members.

Besides, there is a mandatory review requirement and to review only monthly information system is not sufficient. Here the audit committee members reviewed only monthly information system of the company and the same is not sufficient as per clause 49.

The Audit Committee shall mandatorily review the following information as per Clause 49:

1. Management discussion and analysis of financial condition and results of operations;
2. Statement of significant related party transactions (as defined by the Audit Committee), submitted by management;
3. Management letters / letters of internal control weaknesses issued by the statutory auditors;
4. Internal audit reports relating to internal control weaknesses; and
5. The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.

Applying the above, the decision taken by the audit committee is not in line with the clause 49 of the (SEBI) Listing Agreement.

Question 2

Write short notes on Content of Management Discussion and Analysis.

(4 Marks, November, 2013)

Answer

Content of Management Discussion and Analysis:

1. As part of the directors' report or as an addition thereto, a Management Discussion and Analysis report should form part of the Annual Report to the shareholders. This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company's competitive position:
   (i) Industry structure and developments.
   (ii) Opportunities and Threats.
   (iii) Segment–wise or product-wise performance.
   (iv) Outlook
   (v) Risks and concerns.
   (vi) Internal control systems and their adequacy.
   (vii) Discussion on financial performance with respect to operational performance.
   (viii) Material developments in Human Resources/Industrial Relations front, including number of people employed.
2. Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)

   Explanation: For this purpose, the term "senior management" shall mean personnel of the company who are members of its core management team excluding the Board of Directors). This would also include all members of management one level below the executive directors including all functional heads.
3. The Code of Conduct for the Board of Directors and the senior management shall be disclosed on the website of the company.

Question 3

State the "Mandatory Review" areas of the audit committee. *(4 Marks, May, 2012)*

Answer

Mandatory Review Areas of the Audit Committee: The Audit Committee shall mandatorily review the following information as per Clause 49 of the Listing Agreement:

1. Management discussion and analysis of financial condition and results of operations;
2. Statement of significant related party transactions (as defined by the Audit Committee), submitted by management;
3. Management letters / letters of internal control weaknesses issued by the statutory auditors;
4. Internal audit reports relating to internal control weaknesses; and
5. The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.

Question 4

State the main features of the Qualified and Independent Audit Committee set up under clause 49 of the listing agreement. *(8 Marks, November, 2008)*

Answer

The main features of a qualified and independent audit committee to be set up under clause 49 of listing agreement are as follows:

1. The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.
2. All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

   Explanation (i): The term "financially literate" means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

   Explanation (ii): A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.
3. The Chairman of the Audit Committee shall be an independent director;
4. The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;
5. The Audit Committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee;
6. The Company Secretary shall act as the secretary to the committee.

Question 5

Elaborate under Clause 49 of the Listing Agreement, who is an Independent Director.

(6 Marks, May, 2008)

Answer

Clause 49 of the listing agreement on Independent Director: As per Clause 49 of the listing agreement, an Independent Director shall mean a non-executive **director, other than a nominee director of the company:**

1. who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience;
2. (i) who is or was not a promoter of the company or its holding, subsidiary or associate company;

   (ii) who is not related to promoters or directors in the company, its holding, subsidiary or associate company;
3. apart from receiving director's remuneration, has or had no pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year;
4. none of whose relatives has or had pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or their promoters, or directors, amounting to two per cent. or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year;
5. who, neither himself nor any of his relatives —

   (i) holds or has held the position of a key managerial personnel or is or has been employee of the company or its holding, subsidiary or associate company in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed;

   (ii) is or has been an employee or proprietor or a partner, in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, of —

      (A) a firm of auditors or company secretaries in practice or cost auditors of the company or its holding, subsidiary or associate company; or

      (B) any legal or a consulting firm that has or had any transaction with the company, its holding, subsidiary or associate company amounting to ten per cent or more of the gross turnover of such firm;

   (iii) holds together with his relatives two per cent or more of the total voting power of the company; or

(iv) is a Chief Executive or director, by whatever name called, of any non-profit organisation that receives twenty-five per cent or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company or that holds two per cent or more of the total voting power of the company;

(v) is a material supplier, service provider or customer or a lessor or lessee of the company;

6. who is not less than 21 years of age.

Question 6

Write short notes on Corporate Governance. *(4 Marks, November, 2004)*

Answer

Corporate Governance: Corporate governance is the system by which companies are directed and controlled by the management in the best interest of the shareholders and others ensuring greater transparency and better and timely financial reporting. The Board of Directors are responsible for governance of their companies. A number of reports and codes of corporate governance have been published internationally.

The Securities and Exchange Board of India (SEBI) had set up a Committee under the Chairmanship of Shri Kumar Manglam Birla to formulate the code of corporate governance. The Securities and Exchange Board of India (SEBI) with the objective to align its provisions to the recently notified provisions of the Companies Act, 2013, ('the Act') has specifically reviewed clause 49 of the Listing Agreement, to adopt leading industry practices on corporate governance and to make the corporate governance framework more effective. The revised clause 49 on corporate governance shall be applicable to all listed companies with effect from 1 October 2014, except for the clause relating to the constitution of a Risk Management Committee which shall apply to the top 100 listed companies by market capitalisation, as at the end of the immediate previous financial year.

Various clauses deal with composition of board, setting-up of audit committee including scope thereof, remuneration of directors, meetings of Board, contents of management discussions and analysis report, etc.

Clause 49 also prescribes that there shall be a separate section on Corporate Governance in the annual reports of company, with a detailed compliance report on Corporate Governance. Non compliance of any mandatory requirement i.e. which is part of the listing agreement with reasons there of and the extent to which the non-mandatory requirements have been adopted, should be specifically highlighted. Further, the entity is required to obtain a certificate from the statutory auditor of the entity as regards compliance of conditions of corporate governance as stipulated in that clause.

A monitoring cell set up by SEBI, will assess compliance by companies with the requirements of clause 49 and report noncompliances to SEBI within 60 days from the end of each quarter. This shows the strong intent of SEBI to not only bring in regulations, but also put in place a monitoring mechanism.

Note: SEBI has revised Clause 49 vide its Circular dated April 17, 2014 with effect from 1 October 2014.

Question 7

Explain the Constitution and functions of Audit Committee under Section 292A of the Companies Act, 1956. *(8 Marks, May, 2004)*

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

10

Audit of Consolidated Financial Statements

Question 1

While doing the audit of consolidated Financial Statements, which current period consolidation adjustments are to be taken into account?

Answer

Current Period Consolidation Adjustments: Current period adjustments are those adjustments that are made in the accounting period for which the consolidation of financial statements is done. Current period consolidation adjustments primarily relate to elimination of intra-group transactions and account balances. While doing the audit of consolidated Financial Statements, current period consolidation adjustments should be taken into account. The auditor should review the memorandum records to verify the adjustment entries made in the preparation of consolidated financial statements. This would also help the auditor in ascertaining whether there is any difference in the elimination. ***Following are the current period consolidation adjustments while making consolidation of financial statements:***

- ***Elimination of intra-group transactions relating to interest or management fees etc.***
- ***Elimination of unrealized intra-group profits on assets acquired from other subsidiaries.***
- ***Elimination of intra-group indebtedness.***
- ***Adjustments for harmonizing different accounting policies of parent unit and its subsidiaries.***
- ***Adjustments for impairment loss that might exist for goodwill.***
- ***Adjustment for significant events that occur between date of financial statements of the parent and of its components when the date/s of financial statements of components are different from the reporting date.***
- ***Determination of movement in equity attributable to the minorities since the date of acquisition of the subsidiary.***
- ***Treatment of minority interests' share of the losses, if such losses exceed the minority interests' share in the equity.***

Question 2

Write short notes on Responsibility of holding company for preparation of Consolidated Financial Statements.

Answer

Responsibility of Holding Company for preparation of Consolidated Financial Statements: As per Section 129(3) of the Companies Act, 2013, where a company has one or more subsidiaries, it shall, in addition to its own financial statements prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own. The responsibility for the preparation and presentation of consolidated financial statements, among other things, is that of the management of the parent/holding company. This includes:

(i) identifying components, and including the financial information of the components to be included in the consolidated financial statements;

(ii) where appropriate, identifying reportable segments for segmental reporting;

(iii) identifying related parties and related party transactions for reporting;

(iv) obtaining accurate and complete financial information from components; and

(v) making appropriate consolidation adjustments.

Apart from the above, the parent ordinarily issues instructions to the management of the component specifying the parent's requirements relating to financial information of the components to be included in the consolidated financial statements. The instructions ordinarily cover the accounting policies to be applied, statutory and other disclosure requirements applicable to the parent, including the identification of and reporting on reportable segments, and related parties and related party transactions, and a reporting timetable.

Question 3

Write short notes on - Permanent Consolidated Adjustments

Answer

Permanent Consolidated Adjustments - Permanent consolidated adjustments are those adjustments that are made only on the first occasion of the preparation and presentation of consolidated financial statements. Permanent consolidated adjustments are:

(a) determination of excess or deficit of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made (determination of goodwill or capital reserve);

(b) determination of the amount of equity attributable to minorities at the date on which investment in subsidiary is made; and

(c) determination of goodwill or capital reserve arising on application of equity method to account for investments in associates in consolidated financial statements.

Question 4

R Ltd. owns 51% voting power in S Ltd. It however holds and discloses all the shares as "Stock-in-trade" in its accounts. The shares are held exclusively with a view to their subsequent disposal in the near future. R Ltd. represents that while preparing Consolidated Financial Statements, S Ltd. can be excluded from the consolidation. As a Statutory Auditor, how would you deal?

Answer

Consolidation of Financial Statement: AS 21 "Consolidated Financial Statements", states that a subsidiary should be excluded from consolidation when:

(i) Control is intended to be temporary because the shares are acquired and held exclusively with a view to its subsequent disposal in the near future or

(ii) Subsidiary operates under severe long term restrictions which significantly impair its ability to transfer funds to the parent.

Where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and all the shares held as 'stock-in-trade' are acquired and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise would be considered temporary and the investments in such subsidiaries should be accounted for in accordance with AS 13 "Accounting for Investments".

However, as per Section 129(3) of the Companies Act, 2013 read with rule 6 of the Companies (Accounts) Rules, 2014, where a company having subsidiary, which is not required to prepare consolidated financial statements under the Accounting standards, it shall be sufficient if the company complies with the provisions on consolidated financial statements provided in Schedule III to the Act.

In this case, R Ltd's intention is to dispose off the shares in the near future as shares are being held as stock in trade and it is quite clear that the control is temporary, however for the compliance of provisions related to consolidation of financial statements given under the Section 129(3) of the Companies Act, 2013 read with Companies (Accounts) Rules, 2014, R Ltd. is required to consolidate the financial statements as per the provisions on consolidated financial statements provided in Schedule III to the Act.

Question 5

H Limited, a company registered with SEBI, has three subsidiaries and one associate. While doing the audit of Consolidated Financial Statements (CFS) of H Limited you have come to know that the associate entity had made a provision for proposed dividend in its financial statements. H Limited computed its share of the results of operations of the associate after taking into account the proposed dividend. Comment.

Answer

As per AS 23 on "Accounting for Investments in Associates in Consolidated Financial Statements", adjustments to the carrying amount of investment in an investee arising from changes in the investee's equity that have not been included in the statement of profit and loss of the investee are directly made in the carrying amount of investment without routing it through the consolidated statement of profit and loss. The corresponding debit/credit is made in the relevant head of the equity interest in the consolidated balance sheet. For example, in case the adjustment arises because of revaluation of fixed assets by the investee, apart from adjusting the carrying amount of investment to the extent of proportionate share of the investor in the revalued amount, the corresponding amount of revaluation reserve is shown in the consolidated balance sheet.

In case an associate has made a provision for proposed dividend in its financial statements, the investor's share of the results of operations of the associate is computed without taking in to consideration the proposed dividend.

Applying the above provisions to the given problem, H Limited should have computed its share of the results of operations of the associate without taking into consideration the proposed dividend. Therefore, treatment made by H Ltd is not correct.

10

Audit of Consolidated Financial Statements

Question 1

H Limited, a company registered with SEBI, has three subsidiaries and one associate. While doing the audit of Consolidated Financial Statements (CFS) of H Limited you have come to know that the associate entity had made a provision for proposed dividend in its financial statements. H Limited computed its share of the results of operations of the associate after taking into account the proposed dividend. Comment. (4 Marks, November, 2013)

Answer

As per AS 23 on "Accounting for Investments in Associates in Consolidated Financial Statements", adjustments to the carrying amount of investment in an investee arising from changes in the investee's equity that have not been included in the statement of profit and loss of the investee are directly made in the carrying amount of investment without routing it through the consolidated statement of profit and loss. The corresponding debit/credit is made in the relevant head of the equity interest in the consolidated balance sheet. For example, in case the adjustment arises because of revaluation of fixed assets by the investee, apart from adjusting the carrying amount of investment to the extent of proportionate share of the investor in the revalued amount, the corresponding amount of revaluation reserve is shown in the consolidated balance sheet.

In case an associate has made a provision for proposed dividend in its financial statements, the investor's share of the results of operations of the associate is computed without taking in to consideration the proposed dividend.

Applying the above provisions to the given problem, H Limited should have computed its share of the results of operations of the associate without taking into consideration the proposed dividend. Therefore, treatment made by H Ltd is not correct.

Question 2

Write short notes on Permanent Consolidated Adjustments. (4 Marks, May, 2013)

Answer

Permanent Consolidated Adjustments - Permanent consolidated adjustments are those adjustments that are made only on the first occasion of the preparation and presentation of consolidated financial statements. Permanent consolidated adjustments are:

(a) determination of excess or deficit of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made (determination of goodwill or capital reserve);

(b) determination of the amount of equity attributable to minorities at the date on which investment in subsidiary is made; and

(c) determination of goodwill or capital reserve arising on application of equity method to account for investments in associates in consolidated financial statements.

Question 3

Write short notes on Responsibility of holding company for preparation of Consolidated Financial Statements. (4 Marks, November, 2012)

Answer

Responsibility of Holding Company for preparation of Consolidated Financial Statements: As per Section 129(3) of the Companies Act, 2013, where a company has one or more subsidiaries, it shall, in addition to its own financial statements prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own. The responsibility for the preparation and presentation of consolidated financial statements, among other things, is that of the management of the parent/holding company. This includes:

(i) identifying components, and including the financial information of the components to be included in the consolidated financial statements;

(ii) where appropriate, identifying reportable segments for segmental reporting;

(iii) identifying related parties and related party transactions for reporting;

(iv) obtaining accurate and complete financial information from components; and

(v) making appropriate consolidation adjustments.

Apart from the above, the parent ordinarily issues instructions to the management of the component specifying the parent's requirements relating to financial information of the components to be included in the consolidated financial statements. The instructions ordinarily cover the accounting policies to be applied, statutory and other disclosure requirements applicable to the parent, including the identification of and reporting on reportable segments, and related parties and related party transactions, and a reporting timetable.

Question 4

While doing the audit of consolidated Financial Statements, which current period consolidation adjustments are to be taken into account? (8 Marks, June, 2009)

Answer

Current Period Consolidation Adjustments: Current period adjustments are those adjustments that are made in the accounting period for which the consolidation of financial statements is done. Current period consolidation adjustments primarily relate to elimination of

intra-group transactions and account balances. While doing the audit of consolidated Financial Statements, current period consolidation adjustments should be taken into account. The auditor should review the memorandum records to verify the adjustment entries made in the preparation of consolidated financial statements. This would also help the auditor in ascertaining whether there is any difference in the elimination. Following are the current period consolidation adjustments while making consolidation of financial statements:

- Elimination of intra-group transactions relating to interest or management fees etc.
- Elimination of unrealized intra-group profits on assets acquired from other subsidiaries.
- Elimination of intra-group indebtedness.
- Adjustments for harmonizing different accounting policies of parent unit and its subsidiaries.
- Adjustments for impairment loss that might exist for goodwill.
- Adjustment for significant events that occur between date of financial statements of the parent and of its components when the date/s of financial statements of components are different from the reporting date.
- Determination of movement in equity attributable to the minorities since the date of acquisition of the subsidiary.
- Treatment of minority interests' share of the losses, if such losses exceed the minority interests' share in the equity.

Question 5

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

R Ltd. owns 51% voting power in S Ltd. It however holds and discloses all the shares as "Stock-in-trade" in its accounts. The shares are held exclusively with a view to their subsequent disposal in the near future. R Ltd. represents that while preparing Consolidated Financial Statements, S Ltd. can be excluded from the consolidation. (5 Marks, May, 2008)

Answer

Consolidation of Financial Statement: AS 21 "Consolidated Financial Statements", states that a subsidiary should be excluded from consolidation when:

(i) Control is intended to be temporary because the shares are acquired and held exclusively with a view to its subsequent disposal in the near future or

(ii) Subsidiary operates under severe long term restrictions which significantly impair its ability to transfer funds to the parent.

Where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and all the shares held as 'stock-in-trade' are acquired and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise would be considered temporary and the investments in such subsidiaries should be accounted for in accordance with AS 13 "Accounting for Investments".

However, as per Section 129(3) of the Companies Act, 2013 read with rule 6 of the Companies (Accounts) Rules, 2014, where a company having subsidiary, which is not required to prepare consolidated financial statements under the Accounting standards, it shall be sufficient if the company complies with the provisions on consolidated financial statements provided in Schedule III to the Act.

In this case, R Ltd's intention is to dispose off the shares in the near future as shares are being held as stock in trade and it is quite clear that the control is temporary, however for the compliance of provisions related to consolidation of financial statements given under the Section 129(3) of the Companies Act, 2013 read with Companies (Accounts) Rules, 2014, R Ltd. is required to consolidate the financial statements as per the provisions on consolidated financial statements provided in Schedule III to the Act.

11

Audit of Banks

Question 1

Your firm has been appointed as Central Statutory Auditors of a Nationalised Bank. The Bank follows financial year as accounting year. State your views on the following issues which were brought to your notice by your Audit Manager:

(a) The bank has recognised on accrual basis income from dividends on securities and Units of Mutual Funds held by it as at the end of financial year. The dividends on securities and Units of Mutual Funds were declared after the end of financial year.

(b) The bank is a consortium member of Cash Credit Facilities of ₹ 50 crores to X Ltd. Bank's own share is ₹ 10 crores only. During the last two quarters against a debit of ₹ 1.75 crores towards interest the credits in X Ltd's account are to the tune of ₹ 1.25 crores only. Based on the certificate of lead bank, the bank has classified the account of X Ltd as performing.

Answer

(a) It is not a prudent practice to treat dividend on shares of corporate bodies and units of mutual funds as income unless these are actually received. Accordingly, income from dividend on shares of corporate bodies and units of mutual funds should be booked on cash basis. In respect of income from government securities and bonds and debentures of corporate bodies, where interest rates on these instruments are pre-determined, income could be booked on accrual basis, provided interest is serviced regularly and as such is not in arrears. It was further, however, clarified that banks may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the central government or a State government. Banks may book income from dividend on shares of corporate bodies on accrual basis, provided dividend on the shares has been declared by the corporate body in its annual general meeting and the owner's right to receive payment is established. This is also in accordance with AS 9 as well. In the instant case, therefore, the recognition of income by the bank on accrual basis is not in order.

(b) The bank is a consortium member of cash credit facilities of ₹ 50 crores to X Ltd. Bank's own share is ₹ 10 crores only. During the last two quarters against a debit of ₹ I.75 crores towards interest, the credits in X Ltd's account are to the tune of ₹ 1.25 crores only. Sometimes, several banks form a group (the 'consortium') under the leadership of a 'lead bank' to make advance to a large customer on same conditions and security with proportionate rights. In such cases, each bank may classify the advance given by it according to its own experience of recovery and other factors. Since in the last two quarters, the amount remains outstanding and, thus, interest amount should be reversed. This is despite the certificate of lead bank to classify that the account as performing. Accordingly, the amount should be shown as non-performing asset.

Question 2

What is the income recognised in the case of 'non-performing' assets of bank?

Answer

Income Recognition: As per the master circular issued by RBI (DBOD.No.BP.BC.1/ 21.04.048/2013-14 dated July 1, 2013) relating to Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, the banks may book income in the following manner:

(i) Income from NPAs is not recognised on accrual basis but is booked as income only when it is actually received. However, interest on advances against term deposits, NSCs, IVPs, KVPs and Life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.

(ii) Fees and commissions earned by the banks as a result of renegotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the renegotiated or rescheduled extension of credit.

(iii) If Government guaranteed advances become NPA, the interest on such advances should not be taken to income account unless the interest has been realised.

Question 3

Describe the procedure for verification of the following balances appearing in the account books of a bank:

(a) Drafts paid without advice

(b) Branch adjustment account

Answer

(a) Drafts paid without advice: This balance is in the nature of a suspense account in as much as it represents payments made on account of drafts issued by other branches but for which the relevant advice from those branches have not been received. It is, therefore, most important to examine the system of internal control operating in the bank in this respect. The testing of the internal control system has to be made mainly with regard to the following:

(i) the system of verifying the authenticity of the draft by reference to specimen signature of the signing authority and the *prima facie* correctness and completeness of the draft in all respects;

(ii) the system of co-relating drafts paid with advices subsequently received; and

(iii) the system of sending reminders where advices are not received within a reasonable time and the recording of reasons for their non receipt.

The composition of the balances appearing in this account should be verified with particular reference to any long outstanding items. The auditor should also verify whether the items appearing in this account have been subsequently cleared on receipt of the relevant advices. It would also be useful to have on record the names and addresses of the payees of such drafts. The auditor may also seek confirmation of transactions relating to such outstanding cases.

(b) Branch Adjustment Account: In the final balance sheet of the bank, this balance represents the difference between inter branch debits and credits and should normally comprise items which are in transit as on the closing date. This account is the one which is most commonly used by unscrupulous persons in committing a fraud. The verification of this account is, therefore, of great importance. The procedure for verification is as follows:

(i) See that all branch accounts are periodically reconciled.

(ii) Check all adjustments in the account and ensure that the adjustments are done properly and supported by adequate documentary evidence as to its validity.

(iii) Verify that reversal entries are made under proper authority and after due explanation and evidence.

Question 4

As a branch auditor of a nationalised bank, how would you verify the following?

(a) Advances to DOT COM Companies.

(b) Balances in account of a bank situated in a foreign country.

Answer

(a) Advances to DOT COM Companies

(i) Evaluate the efficacy of internal control system in general to ascertain whether an advance is made only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank. The sanction for an advance must specify, among other things, the limit of borrowing, nature of security, margin to be kept, interest, terms of repayment, etc. Also see that all the necessary documents, e.g., agreements, demand promissory notes, letters of hypothecation, etc. have been executed by the parties before advances are made.

(ii) Examine loan documents such as certificate of commencement of business, resolution of board of directors, and resolution of shareholders.

(iii) Verify the business plan of the company especially where the revenue model is in place. Verify whether the company depends only on outside funding or can self generate funds.

(iv) Examine in case the security is in the form of mortgage, apart from mortgage deed (in the case of English Mortgage) or letter of intent to create mortgage (in the case of Equitable Mortgage), the evidence of registration of the charge with the Registrar of Companies.

(v) Review the operation of advance account to see that limit is not generally exceeded; that the account is not becoming stagnant; that the customer is not drawing against deposits which are not free from lien; that the account is not window-dressed by running down overdrafts at the year end and again drawing further advances in the new year, etc.

(vi) Examine whether there is a healthy turnover in the account. It should be seen that the frequency and the amounts of credits in the account are commensurate with the sanctioned limit and the nature and volume of business of the borrower. Any unusual items in the account should be carefully examined by the auditor. If the auditor's review indicates any unhealthy trends, the account should be further examined. The auditor's examination should also cover transactions in the post-balance sheet date period. Large transactions in major accounts particularly as at the year-end may be looked into to identify any irregularities in these accounts.

(vii) Review periodic statements, cash flow statements, latest financial statements, etc. to assess the recoverability of advances.

(viii) Verify whether the advance is secured and determine whether the security is legally enforceable, i.e., whether the necessary legal formalities regarding documentation, registration, etc., have been complied with; whether the security is in the effective control of the bank; and to what extent the value of the security, assessed realistically, covers the amount outstanding in the advance.

(ix) Ensure that proper provisioning norms have been applied in view of non-observance of terms, coupled with irregular payment of interest and default in repayment of instalments, if any.

(b) Balances in Account of a Bank situated in a Foreign Country

(i) Verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at the year-end.

(ii) Review the reconciliation statements and pay particular attention to the following.

(1) Examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to revenue for the year have been so taken. This should be particularly observed when the bills collected, etc., are credited with net amount and entries for commission, etc. are not made separately in the statement of account.

(2) Examine that no cheque sent or received in clearing is outstanding. As per the practice prevalent among banks, any cheques returned unpaid are accounted for on the same day on which they were sent in clearing or on the following day.

(3) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.

(iii) Examine the large transactions in inter-bank accounts, particularly towards the year-end, to ensure that no transactions have been put through for window-dressing.

(iv) Check original deposit receipts in respect of balances in deposit accounts in addition to confirmation certificates obtained from banks in respect of outstanding deposits.

(v) Check whether these balances are converted into the Indian currency at the exchange rates prevailing on the balance sheet date and ensure compliance with AS 11 on "Accounting for the Effects of Changes in Foreign Exchange Rates".

Question 5

Describe the audit procedures to be followed by a Statutory Auditor of a bank for audit of contingent liabilities.

Answer

Verification of Contingent Liabilities: In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified and properly valued. To this end, the auditor should, generally follow the audit procedures given below:

(i) the auditor should ensure that there exists a system whereby the non fund based facilities or additional/*ad hoc* credit facilities to parties are extended only to their regular constituents, etc.

(ii) Ascertain whether there are adequate internal controls to ensure that transactions giving rise to contingent liabilities are executed only by persons authorised to do so and in accordance with the laid down procedures.

(iii) The auditor should also ensure that in case of LCs for import of goods, as required by the abovementioned Master Circular on guarantees and co-acceptances, the payment to the overseas suppliers is made on the basis of shipping documents and after ensuring that the said documents are in strict conformity with the terms of LCs.

(iv) Ascertain whether the accounting system of the bank provides for maintenance of adequate records in respect of such obligations and whether the internal controls ensure that contingent liabilities are properly identified and recorded.

(v) Performs substantive audit tests to establish the completeness of the recorded obligations. Such tests include confirmation procedures as well as examination of relevant records in appropriate cases.

(vi) Review the reasonableness of the year-end amount of contingent liabilities in the light of previous experience and knowledge of the current year's activities.

(vii) Review whether comfort letters issued by the bank has been considered for disclosure of contingent liabilities.

(viii) Obtain representation from the management that-

(a) all contingent liabilities have been disclosed;

(b) the disclosed contingent liabilities do not include any contingencies which are likely to result in a loss/ expense and which, therefore, require creation of a provision in the financial statements;

(c) the estimated amounts of financial effect of the contingent liabilities are based on the best estimates in terms of Accounting Standard 29, including any possibility of any reimbursement;

(d) in case of guarantees issued on behalf of the bank's directors, the bank has taken appropriate steps to ensure that adequate and effective arrangements have been made so that the commitments would be met out of the party's own resources and that the bank will not be called upon to grant any loan or advances to meet the liability consequent upon the invocation of the said guarantee(s) and that no violation of section 20 of the Banking Regulations Act, 1949 has arisen on account of such guarantee; and

(e) such contingent liabilities which have not been disclosed on account of the fact that the possibility of their outcome is remote, include the management's justification for reaching such a decision in respect of those contingent liabilities.

(ix) The auditor should also examine whether the bank has given any guarantees in respect of any trade credit (buyer's credit or seller's credit). The period of guarantees is co-terminus with the period of credit reckoned from the date of shipment.

(x) Verify whether bank has extended any non-fund facility or additional/*ad hoc* credit facilities to other than its regular customers. In such cases, auditor should ensure concurrence of existing bankers of such borrowers and enquire regarding financial position of those customers.

Question 6

Discuss the concurrent audit system in commercial banks.

Answer

Scope of concurrent audit: Concurrent audit is an examination which is contemporaneous with the occurrence of transactions or is carried out as near thereto as possible. It attempts to shorten the interval between a transaction and its examination by an independent person not involved in its documentation. There is an emphasis in favour of substantive checking in key areas rather than test checking. This audit is essentially a management process integral to the establishment of sound internal accounting functions and effective controls and setting the tone for a vigilance internal audit to preclude the incidence of serious errors and fraudulent manipulations.

A concurrent auditor may not sit in judgement of the decisions taken by a branch manager or an authorised official. This is beyond the scope of concurrent audit. However, the audit will necessarily have to see whether the transactions or decisions are within the policy parameters laid down by the Head Office, they do not violate the instructions or policy prescriptions of the RBI, and that they are within the delegated authority.

In very large branches, which have different divisions dealing with specific activities, concurrent audit is a means to the incharge of the branch to ensure on an on going basis that

the different divisions function within laid-down parameters and procedures.

Coverage

(i) The Departments/Divisions at the Head Office dealing with Treasury functions viz investments, funds management including inter-bank borrowings bill rediscount and foreign exchange business are to be subjected to concurrent audit. In addition, all branch offices, undertaking such business and dealing rooms have to be subjected to continuous audit.

(ii) The coverage of branches should ensure that concurrent audit covers:

  (a) Branches whose total credit and other risk exposures aggregate to not less than 50% of the total credit and other risk exposures of the bank; and

  (b) Branches whose aggregate deposits cover not less than 50% of the aggregate deposits of the Bank.

(iii) To achieve these twin criteria it is suggested that branches may be listed according to credit and other risk exposures and selected in the descending order of exposures to achieve a 50% coverage. If the deposits of these branches do not aggregate to 50% of the Bank's deposits, additional branches in descending order of deposits may be added to achieve a 50% coverage of the branches.

(iv) While complying with the above parameters, it is necessary to ensure that the coverage encompasses:

- exceptionally large branches
- very large and large branches
- special branches handling foreign exchange business, merchant banking business, large corporate wholesale banking business and forex dealing room operations
- large problem branches rated as poor/very poor
- Head Office department dealing with treasury/funds management and handling investment portfolio
- any other branches or departments where in the opinion of the Bank concurrent audit is desirable.

(v) Branches subjected to concurrent audit should not normally be included for revenue/income audit.

Types of activities to be covered

(i) The main role of concurrent audit is to supplement the efforts of the bank in carrying out simultaneous internal check of the transactions and other verifications and compliance with the procedures laid down.

(ii) The scope of concurrent audit should be wide enough to cover certain fraud-prone areas like handling of cash, deposits, safe custody of securities, investments, overdue bills, exercise of discretionary powers, sundry and suspense accounts, inter-branch reconciliation, clearing differences, foreign exchange business including Nostro accounts, off-balance sheet items like letters of credit and guarantee, treasury functions and credit-card business.

(iii) The detailed scope of the concurrent audit should be clearly and uniformly determined for the Bank as a whole by the Bank's Inspector and Audit Department in consultation with the Bank's Audit Committee of the Board of Directors (ACB).

(iv) In determining the scope, importance should be given to checking high-risk transactions having large financial implications as opposed to transactions involving small amounts.

(v) While the detailed scope of the concurrent audit may be determined and approved by the ACB.

Question 7

As statutory central auditors of a Nationalized bank, what special points are to be borne in mind in the audit of compliance with "Statutory Liquidity Ratio" (SLR) requirements?

Answer

'Statutory Liquidity Ratio' requirements: The RBI vide its Master circular No. RBI/2013-14/64 DBOD.No.Ret.BC. 19 /12.01.001/2013-14 on "Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)" dated July 1, 2013, has specified that consequent upon amendment to the Section 24 of the Banking Regulation Act, 1949 through the Banking Regulation (Amendment) Act, 2007 replacing the Regulation (Amendment) Ordinance, 2007, effective January 23, 2007, the Reserve Bank can prescribe the Statutory Liquidity Ratio (SLR) for Scheduled Commercial Banks in specified assets. The value of such assets of a SCB shall not be less than such percentage not exceeding 40 per cent of its total demand and time liabilities in India as on the last Friday of the second preceding fortnight as the Reserve Bank may, by notification in the Official Gazette, specify from time to time.

Further, Reserve Bank has specified vide notification DBOD.No.Ret.32/12.02.001/2012-13 dated July 31, 2012 that w.e.f. the fortnight beginning August 11, 2012 every Scheduled Commercial Bank shall continue to maintain in India assets as detailed below, the value of which shall not, at the close of business on any day, be less than 23 per cent on the total net demand and time liabilities as on the last Friday of the second preceding fortnight valued in accordance with the method of valuation specified by the Reserve Bank of India from time to time:

(i) Cash or

(ii) Gold valued at a price not exceeding the current market price, or

(iii) Investment in the following instruments which will be referred to as "Statutory Liquidity Ratio (SLR) securities":

  (a) Dated securities issued up to May 06, 2011as listed in the Annex to Notification DBOD.No.Ret.91/12.02.001/2010-11 dated May 09, 2011;

  (b) Treasury Bills of the Government of India;

(c) Dated securities of the Government of India issued from time to time under the market borrowing programme and the Market Stabilization Scheme;

(d) State Development Loans (SDLs) of the State Governments issued from time to time under the market borrowing programme; and

(e) Any other instrument as may be notified by the Reserve Bank of India.

It is also provided that the securities (including margin) referred to above, if acquired under the Reserve Bank- Liquidity Adjustment Facility (LAF), shall not be treated as an eligible asset for this purpose.

Compliance with SLR Requirements: The Reserve Bank of India requires statutory central auditors of banks to verify the compliance with SLR requirements of 12 odd dates in different months of a financial year not being Fridays. The resultant report is to be sent to the top management of the bank and to the Reserve Bank. The report of the statutory auditors in relation to compliance with SLR requirements has to cover two aspects:

(i) correctness of the compilation of DTL position; and

(ii) maintenance of liquid assets as specified in section 24 of the Act.

Audit approach and procedure:

(i) Obtain an understanding of the relevant circumstances of the RBI, particularly regarding composition of items of DTL.

(ii) Require the branch auditors to send their weekly trial balance as on Friday and these are consolidated at the head office. Based on this consolidation, the DTL position is determined for every reporting Friday. The statutory central auditor should request the branch auditors to verify the correctness of the trial balances relevant to the dates selected by him. The branch auditors should also be specifically requested to examine the cash balance at the branch on the selected dates.

(iii) Review the relevant returns received from un-audited branches to identify any obvious errors or omissions or inconsistencies.

(iv) Examine, on a test basis, the consolidations regarding DTL position prepared by the bank with reference to the related returns received from branches. The auditor should examine whether the valuation of securities done by the bank is in accordance with the guidelines prescribed by the RBI.

(v) While examining the computation of DTL, specifically examine that the following items have been excluded from liabilities-

(a) Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery.

(b) Amounts received in Indian currency against import bills and held in sundry deposits pending receipts of final rates.

(c) Un-adjusted deposits/balances lying in link branches for agency business like dividend warrants, interest warrants, refund of application money, etc., in respect of shares/debentures to the extent of payment made by other branches but not adjusted by the link branches.

(d) Margins held and kept in sundry deposits for funded facilities-

(vi) Similarly, specifically examine that the following items have been included in liabilities-

(a) Net credit balance in branch adjustment accounts including these relating to foreign branches.

(b) Interest on deposit as at the end of the firm half year reversed in the beginning of the next half-year.

(vii) Test check the relevant records maintained by the bank in respect of investments to verify the amount of approved securities held by the bank on the dates selected by him Examine whether the valuation of approved securities has been done by the bank is in accordance with the guidelines prescribed by the RBI.

(viii) While reporting on compliance with SLR requirements, the auditor should specify the number of unaudited branches and state that he has relied on the returns received from the unaudited branches in forming his opinion.

Question 8

Write a short note on - Principal Enactments Governing Bank Audit.

Answer

Principal Enactments Governing Bank Audit: There is an elaborate legal framework governing the functioning of banks in India. The principal enactments which govern the functioning of various types of banks are-

(i) Banking Regulation Act, 1949.

(ii) State Bank of India Act, 1955.

(iii) Companies Act, 2013.

(iv) State Bank of India (Subsidiary Banks) Act, 1959.

(v) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970.

(vi) Regional Rural Banks Act, 1976.

(vii) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.

(viii) Information Technology Act, 2000.

(ix) Prevention of Money Laundering Act, 2002.

(x) Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

(xi) Credit Information Companies Regulation Act, 2005.

(xii) Payment and Settlement Systems Act, 2007.

Besides, the above enactments, the provisions of the Reserve Bank of India Act, 1934, also affect the functioning of banks. The Act gives wide powers to the RBI to give directions to banks which also have considerable effect on the functioning of banks.

Question 9

What are the exceptions to the general rule of treating advances as Non-performing Assets (NPAs)?

Answer

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.

(iiii) **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.

Question 10

Write a short note on - Vostro and Nostro Accounts.

Answer

Vostro and Nostro Accounts: Bank's maintain stocks of foreign currencies in the form of Bank Accounts with their overseas branches/correspondents. Such foreign currency accounts maintained by Indian banks at other overseas centres are designated by it as "Nostro Account". For example, all banks in India would be maintaining a US Dollar Account with their New York office/branch/correspondents, such account would be designated by the Indian office as Nostro Account. "Vostro Account" is the opposite of Nostro accounts. Here a foreign bank in another country maintains stocks of Indian rupees with their Indian branch/ correspondent/local bank. Such Indian Rupee Accounts are designated as a Vostro Account. For example, a German Bank might maintain a Vostro Account in rupees in terms with Indian Bank. While examining the transaction in foreign exchange, the auditor should also pay attention to reconciliation of Nostro Accounts with the respective minor account. The amount in the Nostro account is stock of foreign currency in the form of bank accounts with the overseas branches and correspondents. Unreconciled Nostro Accounts, on an examination, may reveal unauthorized payments from the foreign currency account, unauthorized withdrawals, and unauthorized debit to minor account. The auditor should also evaluate the internal control with regard to inward/ outward messages. The inward/ outward messages should be properly authenticated and discrepancies noticed, should be properly dealt with, in the books of accounts.

The auditor should also verify whether prescribed procedure in relation to inter bank confirmation in the Vostro account is followed or not. In case balance confirmation certificate have been received but the same have not been reconciled, or where confirmation has not been received the same should be reported, in respect of each Vostro Account.

Question 11

Explain the scope of concurrent audit of a bank with reference to Reserve Bank of India guidelines.

Answer

Scope of concurrent audit of banks with reference to RBI guidelines: The following are the areas to be covered-

(i) Daily cash transactions with reference to abnormal receipts and payments. This will include currency chest transactions, major expenses met by cash, high value receipts and disbursements.

(ii) Purchase and sale of shares securities etc. Physical verification of investments and rates at which they are entered into.

(iii) Verification of procedure and documentation to open new current, savings, term deposit accounts, etc. Unusual operations noticed have to be thoroughly examined.

(iv) Verification of advances, overdrafts, temporary OD, Cash credit accounts, term loans, bills purchase, letters of credit etc. Procedure for sanction and documentation to be verified. Any deviation noticed to be examined in great detail.

(v) Foreign exchange transactions to be verified with reference to RBI guidelines.

(vi) Verification of balancing of all ledgers and registers, inter branch reconciliation calculation and verification of interest, discount, commission etc.

(vii) Revenue leakage to be detected.

(viii) Special efforts to be made in all fraud prone areas. The attempt should be to ensure that all effective measures are taken to prevent frauds.

(ix) Verification of high value transactions.

(x) Procedure for safe custody of security forms with the branch.

(xi) Whether all procedures for tax deduction at source are followed and the tax so deducted are deposited into Government Account within the time fixed.

(xii) Verification of returns, statements, calculation of capital adequacy ratio and compliance with requirements of government business.

(xiii) Study of RBI and Internal Inspection reports statutory auditors report and compliance thereto.

(xiv) Whether the customers' complaints are dealt with promptly.

Question 12

How would you verify "Acceptances, Endorsements and other obligations" appearing in the Balance Sheet of a bank?

Answer

Acceptances, Endorsements and Other Obligations: This item includes the following balances-

(a) letters of credit opened by the bank on behalf of its customers and

(b) bills drawn by the bank's customers and accepted/endorsed by the bank.

Letters of credit: Evaluate the adequacy of the internal controls over LC Forms e.g. custody, maintenance of records, periodical verification, reconciliation etc.

Verify the balance of LC from the Register maintained by the bank to ascertain the amount of LC and payments made under them.

Examine the guarantees of the customers, copies of the LC issued & security obtained for issuing LC.

In respect of other acceptances and endorsements the following procedure may be adopted:

(i) Examine the arrangements made by the bank with its customers.

(ii) Test check the amounts of bills with the register maintained by the bank.

(iii) Verify whether such bills are marked off in the register on payment at maturity.

Letters of comfort: Where letters of comfort has been issued, verify whether the bank has incurred a potential financial obligation under such a letter. If an obligation has been cast under letters of comfort, ensure that the amount has also been shown as contingent liability in the Balance Sheet.

Question 13

How are investments to be classified in the financial statements of a Bank?

Answer

Classification of Investments in the Financial Statements of a Bank: The entire investment portfolio of the banks (including SLR securities and non-SLR securities) should be classified under three categories viz., 'Held to Maturity', 'Available for Sale' and 'Held for Trading'.

However, in the balance sheet, the investments will continue to be disclosed as per the existing six classifications viz., (a) Government securities; (b) Other approved securities; (c) Shares; (d) Debentures & Bonds; (e) Subsidiaries/Joint Ventures and (f) Other (CP, Mutual Fund Units, etc.).

Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposals.

Held to maturity

(i) The securities acquired by the banks with the intention to hold them up to maturity will be classified under *Held to Maturity.*

(ii) The investments included under 'Held to maturity' should not exceed 25 per cent of the bank's total investments.

The following investments are to be classified under 'Held to Maturity' but will not be counted for the purpose of ceiling of 25% specified for the category:

(i) Re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in their investment portfolio.

(ii) Investment in subsidiaries and joint ventures. [A joint venture would be one in which the bank, along with its subsidiaries, holds more than 25% of the equity.]

(iii) ***The investments in long-term bonds, issued by companies engaged in infrastructure activities. The minimum residual maturity of seven years should be at the time of investment in these bonds. Once invested, banks may continue to classify these investments under HTM category even if the residual maturity falls below seven years subsequently.***

Held for Trading

The securities acquired by the banks with the intention to trade by taking advantage of the short-term price/interest rate movements will be classified under *Held for Trading.*

The investments classified under held for trading category would be those from which the bank expects to make a gain by the movement in the interest rates/market rates. These securities are to be sold within 90 days.

Available for Sale

The securities which do not fall within the above two categories will be classified under *Available for Sale*.

Profit or Loss on sale of investments in both the categories will be taken to the Profit & Loss Account.

Question 14

Write a short a note on - Contingent Liabilities for Banks.

Answer

Contingent Liabilities for Banks: The Third Schedule to the Banking Regulation Act, 1949, requires the disclosure of the following as a footnote to the balance sheet.

(a) *Contingent liabilities*

(i) Claims against the bank not acknowledged as debts.

(ii) Liability for partly paid investments.

(iii) Liability on account of outstanding forward exchange contracts.

(iv) Guarantees given on behalf of constituents-

(1) In India.

(2) Outside India.

(v) Acceptances, endorsements and other obligations.

(vi) Other items for which the bank is contingently liable.

(b) *Bills for collection*.

Question 15

(a) What do you understand by Long-form Audit Report?

(b) As the concurrent auditor of Nagpur Main Branch of XYZ Bank Ltd. state the issues which have to be considered in the audit of advances.

Answer

(a) Long form Audit Report: The long form Audit Report has to be furnished by the auditor of a bank in addition to the audit report as per the statutory requirement. The matters which the banks require their auditor to deal with in the form of Long Form Audit Report have been specified by Reserve Bank of India.

(b) Audit of advances of a Bank: The items to be covered in the concurrent audit of advances of a bank are as follows-

(i) Ensure that loans and advances have been sanctioned properly (i.e. after due scrutiny and at the appropriate level).

(ii) Verify whether the sanctions are in accordance with delegated authority.

(iii) Ensure that securities and documents have been received and properly charged/ registered.

(iv) Ensure that post disbursement supervision and follow-up is proper, such as receipt of stock statements, instalments, renewal of limits, etc.

(v) Verify whether there is any mis utilisation of the loans and whether there are instances indicative of diversion of funds.

(vi) Check whether the letters of credit issued by the branch are within the delegated power and ensure that they are for genuine trade transactions.

(vii) Check the bank guarantees issued, whether they have been properly worded and recorded in the register of the bank. Whether they have been promptly renewed on the due dates.

(viii) Ensure proper follow-up of overdue bills of exchange.

(ix) Verify whether the classification of advances has been done as per RBI guidelines.

(x) Verify whether the submission of claims to DICGC and ECGC is in time.

(xi) Verify that instances of exceeding delegated powers have been promptly reported to controlling/Head Office by the branch and have been got confirmed or ratified at the required level.

(xii) Verify the frequency and genuineness of such exercise of authority beyond the delegated powers by the concerned officials.

Question 16

How will you evaluate the Internal Control system in the area of Credit Card operations of a Bank?

Answer

Evaluation of Internal Control System in the area of Credit Card Operations in a bank:

(i) There should be effective screening of applications with reasonably good credit assessments.

(ii) There should be strict control over storage and issue of cards.

(iii) There should be a system whereby a merchant confirms the status of unutilised limit of a credit-card holder from the bank before accepting the settlement in case the amount to be settled exceeds a specified percentage of the total limit of the card holder.

(iv) There should be a system of prompt reporting by the merchants of all settlements accepted by them through credit cards.

(v) Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards.

(vi) All the reimbursement (gross of commission) should be immediately charged to the customer's account.

(vii) There should be a system to ensure that statements are sent regularly and promptly to the customer.

(viii) There should be a system to monitor and follow-up customers' payments.

(ix) Items overdue beyond a reasonable period should be identified and attended to carefully. Credit should be stopped by informing the merchants through periodic bulletins, as early as possible, to avoid increased losses.

(x) There should be a system of periodic review of credit card holders' accounts. On this basis, the limits of customers may be revised, if necessary. The review should also include determination of doubtful amounts and the provisioning in respect thereof.

Question 17

(a) While auditing the Branch of a Bank you are required to examine Inter Branch adjustments. Which points require your special attention?

(b) How do you examine claims against the Bank not acknowledged as debts?

Answer

(a) Special points to examine Inter Branch adjustments: 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) Examination of claims against the Bank not acknowledged as debts: The auditor should examine the relevant evidence, for example correspondence with lawyers, claimants, workers/officers and workmen's/officer's unions. The auditor should also review the minutes of the meeting of the Board of directors/committees of the Board, contracts, agreements and arrangements, list of pending legal cases and correspondence relating to taxes, duties etc., to identify claims against the bank. The auditor should ascertain from the management the status of claims outstanding as at the end of previous year. A review of subsequent events would also provide evidence about completeness and valuation of claims.

Question 18

Write a short note on reversal of income under bank audit.

Answer

Reversal of Income: 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).

Question 19

"An asset, including a leased asset, becomes non-performing when it ceases to generate income for the Bank." Define the criteria for classification of non-performing assets.

Answer

Classification of Non-Performing Assets: An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank.

Criteria for the classification of a Non Performing Asset (NPA) is a loan or an advance where-

(i) Interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan.

(ii) The account remains "out of order" in respect of an Overdraft/Cash Credit (OD/CC).

(iii) The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.

(iv) The instalments of principal or interest thereon remain overdue for two crop seasons for short duration crops.

(v) The instalment of principal or interest thereon remains overdue for one crop season for long duration crops.

(vi) The amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitization dated 1st February, 2006.

(vii) In respect of derivative transactions, the overdue receivables representing positive mark to Market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

Question 20

As the concurrent auditor of Z Bank Ltd., you are requested by its management to draft an internal control policy in respect of loans and advances. What factors do you consider as important while drafting such a policy?

Answer

Drafting of Internal control policy for Loans and Advances: The following are the important factors to be considered while drafting internal control policy in respect of loans and advances of a Z bank Ltd.-

(i) The bank should make advances only after satisfying itself as to the creditworthiness of the borrowers and after obtaining sanction from the proper authorities of the bank.

(ii) All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.

(iii) Sufficient margin should be kept against securities taken so as to cover any decline in the value thereof and also to comply with Reserve Bank directives. Such margins should

be determined by the proper authorities of the bank as a general policy or for particular accounts.

(iv) All the securities should be received and returned by responsible officer. They should be kept in the Joint custody of two such officers.

(v) All securities requiring registration should be registered in the name of the bank or otherwise accompanied by the documents sufficient to give title of the bank.

(vi) In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipts. The godowns should be regularly and frequently inspected by a responsible officer of the branch concerned, in addition by the inspectors of the bank.

(vii) Surprise checks should be made in respect of hypothecated goods not in the possession of the bank.

(viii) Market value of goods should be checked by officers of the bank by personal enquiry in addition to the invoice value given by the borrowers.

(ix) As soon as any increase or decrease takes place in the value of securities proper entries should be made in the Drawing Power Book and Daily Balance Book. These entries should be checked by an officer.

(x) All accounts should be kept within both the drawing power and the sanctioned limit at all times.

(xi) All the accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the Management/Head Office regularly.

(xii) The operation in each advance should be reviewed at least once every year.

(xiii) Post disbursement supervision and follow-up should be proper, such as receipt of stock statements, instalments, renewal of limits, etc.

(xiv) There should not be any mis-utilisation of the loans and instances indicative of diversion of funds should be checked.

(xv) Letters of credit issued by the branch should be within the delegated power and should be for genuine trade transactions.

(xvi) Bank guarantees issued, should be properly worded and recorded in the register of the bank. They should be promptly renewed on the due dates.

(xvii) Proper follow-up should be made for overdue bills of exchange.

(xviii) The classification of advances should be done as per RBI guidelines.

(xix) The submission of claims to DICGC and ECGC should be on time.

(xx) Instances of exceeding delegated powers should be promptly reported to controlling/Head Office by the branch and should be got confirmed or ratified at the required level.

Question 21

As a bank branch auditor, what aspects will be considered while reporting on credit appraisal, sanctioning /disbursement and documentation in respect of advances in the LFAR?

Answer

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.

Question 22

In course of audit of Good Samaritan Bank as at 31st March 14 you observed the following:

(a) In a particular account there was no recovery in the past 18 months. The bank has not applied the NPA norms as well as income recognition norms to this particular account. When queried the bank management replied that this account was guaranteed by the central government and hence these norms were not applicable. The bank has not invoked the guarantee. Please respond. Would your answer be different if the advance is guaranteed by a State Government ?

(b) The bank's advance portfolio comprised of significant loans against Life Insurance Policies. Write suitable audit program to verify these advances.

Answer

(a) Government guaranteed advance: If a government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not to be taken to income unless interest is realized. However, for purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government repudiates its guarantee, when invoked.

Since the bank has not revoked the guarantee, the question of repudiation does not arise. Hence the bank is correct to the extent of not applying the NPA norms for provisioning purpose. But this exemption is not available in respect of income recognition norms. Hence the income to the extent not recovered should be reversed.

The situation would be different if the advance is guaranteed by State Government because this exception is not applicable for State Government Guaranteed advances, where advance is to be considered NPA if it remains overdue for more than 90 days.

In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR.

(b) The audit programme to verify advances against Life Insurance Policies is as under-

(i) The auditor should inspect the policies and see whether they are assigned to the bank and whether such assignment has been registered with the insurer.

(ii) The auditor should also examine whether premium has been paid on the policies and whether they are in force.

(iii) Certificate regarding surrender value obtained from the insurer should be examined.

(iv) The auditor should particularly see that if such surrender value is subject to payment of certain premium, the amount of such premium has been deducted from the surrender value.

Question 23

Write short notes on Valuation of Investments "held to maturity" by banks.

Answer

Valuation of Investments "Held to Maturity": The banks are required to classify their entire investment portfolio into three categories: held to maturity (HTM), available for sale (AFS), and held for trading (HFT). Securities acquired with the intention to hold them up to maturity should be classified under HTM category. Thus, this category will comprise only debt securities (e.g., debentures, redeemable bonds, government securities), preference shares and similar securities having a defined period of maturity, except that equity shares of subsidiaries/joint ventures have also to be included in HTM category.

These investments need not be Marked to Market and will be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortized over the period remaining to maturity. For instance if a bond is acquired at say ₹ 90 and it is redeemable at ₹100 after three years, the discount, i.e., ₹10 should also be amortised as income over the next three years unless there is significant uncertainty of receipt of full face value on maturity.

Any diminution, other than temporary should be recognised in the value of their investments in subsidiaries/JVs and provided for. Such diminution should be determined and provided for each investment individually.

Question 24

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

Answer

Verification of advances against goods (Banking Companies):

(i) Sanction: Examine the sanction letter, letter of hypothecation and note the important terms and conditions of the advances.

(ii) Stock statements: Verify the quantity and value of goods hypothecated based on the stock statements received from the borrower. Test check the Godown Register and examine the valuation of goods to ascertain the reasonableness of the same.

(iii) Inspection: Ascertain as to whether the premises of the borrowers are periodically visited by the bank officials to verify the quantity as per the periodic stock statements.

(iv) Stock Audit: See whether the bank has got a system of obtaining stock and receivables audit report in respect of such advances. If so, review the stock audit report and identify adverse comments, if any.

(v) Hypothecation/Pledge: Examine the letter of hypothecation and certificate of registration of charge, in respect of goods pledged with the bank.

(vi) Insurance: Examine the insurance policies for their validity, adequacy etc. and see that policies are in favour of the bank.

(vii) Documents of title: Inspect the documents of title to goods like bill of lading, dock warrant, railway receipts etc to ensure that they are endorsed registered in favour of the bank.

(viii) Third party certificate: Where the hypothecated goods are in possession of third parties, such as clearing and forwarding agents, transporters, bankers, etc. undertaking has been obtained by the bank that they will handover the goods or sale proceeds thereof to the bank only. In such cases, certificate should be obtained by the bank from such third parties regarding quantities on hand, on balance sheet date. The valuation of such goods should be checked by the auditor.

Question 25

While doing the audit of a nationalized bank, your Audit Assistant informed you that there are a lot of irregularities in Telegraphic Transfers and Demand Drafts. What guidance would be given to the Audit Assistant?

Answer

In respect of Telegraphic Transfers and Demand Drafts, the audit assistant would be given the following guidance-

(i) The bank should have a reliable private code known only to responsible officers of its branches, coding and decoding of telegrams should be done only by such officers.

(ii) The signatures on a demand draft should be checked by an officer with the Signature Book.

(iii) All the T.Ts and D.Ds. sold by a branch should be immediately confirmed by the advices to the branches concerned.

(iv) If the paying branch does not receive proper confirmation of any T.T. or D.D. from the issuing branch or does not receive credit in its account with that branch, it should take immediate steps to ascertain the reasons.

Question 26

Shy & Co. had been allotted the branch audit of a nationalized bank for the year ended 31st March, 2014. In the audit planning, the partner of Shy & Co. observed that the allotted branches are predominantly based in rural areas and major portion of the advances were for agricultural purpose. He needs your assistance in incorporating the criteria prescribed for determination of NPA norms in respect of agricultural advance, in audit plan.

Answer

NPA Norms in respect of Agricultural Advance: A loan granted for short duration crops will be treated as Non Performing Asset, if the instalment of principal or interest thereon remains overdue for two crop seasons and, a loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

As per the guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops. The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him.

The above norms should be made applicable to all direct agricultural advances as listed in the Master Circular on Lending to Priority Sectors. In respect of all other agricultural loans, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.

If natural calamities impair the repaying capacity of agricultural borrowers, banks may decide on their own as a relief measure conversion of the short-term production loan into a term loan or re-schedulement of the repayment period; and the sanctioning of fresh short-term loan, subject to guidelines issued by RBI.

11

Audit of Banks

Question 1

While doing the audit of a nationalized bank, your Audit Assistant informed you that there are a lot of irregularities in Telegraphic Transfers and Demand Drafts. What guidance would be give to the Audit Assistant? (4 Marks, November, 2013)

Answer

In respect of Telegraphic Transfers and Demand Drafts, the audit assistant would be given the following guidance-

(i) The bank should have a reliable private code known only to responsible officers of its branches, coding and decoding of telegrams should be done only by such officers.

(ii) The signatures on a demand draft should be checked by an officer with the Signature Book.

(iii) All the T.Ts and D.Ds. sold by a branch should be immediately confirmed by the advices to the branches concerned.

(iv) If the paying branch does not receive proper confirmation of any T.T. or D.D. from the issuing branch or does not receive credit in its account with that branch, it should take immediate steps to ascertain the reasons.

Question 2

In course of audit of Good Samaritan Bank as at 31st March 13 you observed the following:

(a) In a particular account there was no recovery in the past 18 months. The bank has not applied the NPA norms as well as income recognition norms to this particular account. When queried the bank management replied that this account was guaranteed by the central government and hence these norms were not applicable. The bank has not invoked the guarantee. Please respond. Would your answer be different if the advance is guaranteed by a State Government? (5 Marks, May, 2013)

(b) The bank's advance portfolio comprised of significant loans against Life Insurance Policies. Write suitable audit program to verify these advances. (3 Marks, May, 2013)

Answer

(a) Government guaranteed advance: If a government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not to be taken to income unless interest is realized. However, for purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government repudiates its guarantee, when invoked.

Since the bank has not revoked the guarantee, the question of repudiation does not arise. Hence the bank is correct to the extent of not applying the NPA norms for provisioning purpose. But this exemption is not available in respect of income recognition norms. Hence the income to the extent not recovered should be reversed.

The situation would be different if the advance is guaranteed by State Government because this exception is not applicable for State Government Guaranteed advances, where advance is to be considered NPA if it remains overdue for more than 90 days.

In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR.

(b) The audit programme to verify bank's advances against Life Insurance Policies is as under -

(i) The auditor should inspect the policies and see whether they are assigned to the bank and whether such assignment has been registered with the insurer.

(ii) The auditor should also examine whether premium has been paid on the policies and whether they are in force.

(iii) Certificate regarding surrender value obtained from the insurer should be examined.

(iv) The auditor should particularly see that if such surrender value is subject to payment of certain premium, the amount of such premium has been deducted from the surrender value.

Question 3

As the concurrent auditor of Z Bank Ltd you are requested by its management to draft an internal control policy in respect of loans and advances. What factors do you consider as important while drafting such a policy? (10 Marks, May, 2012)

Answer

Drafting of Internal control policy for Loans and Advances: The following are the important factors to be considered while drafting internal control policy in respect of loans and advances of a Z bank Ltd.-

(i) The bank should make advances only after satisfying itself as to the creditworthiness of the borrowers and after obtaining sanction from the proper authorities of the bank.

(ii) All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.

(iii) Sufficient margin should be kept against securities taken so as to cover any decline in the value thereof and also to comply with Reserve Bank directives. Such margins should be determined by the proper authorities of the bank as a general policy or for particular accounts.

(iv) All the securities should be received and returned by responsible officer. They should be kept in the Joint custody of two such officers.

(v) All securities requiring registration should be registered in the name of the bank or otherwise accompanied by the documents sufficient to give title of the bank.

(vi) In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipts. The godowns should be regularly and frequently inspected by a responsible officer of the branch concerned, in addition by the inspectors of the bank.

(vii) Surprise checks should be made in respect of hypothecated goods not in the possession of the bank.

(viii) Market value of goods should be checked by officers of the bank by personal enquiry in addition to the invoice value given by the borrowers.

(ix) As soon as any increase or decrease takes place in the value of securities proper entries should be made in the Drawing Power Book and Daily Balance Book. These entries should be checked by an officer.

(x) All accounts should be kept within both the drawing power and the sanctioned limit at all times.

(xi) All the accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the Management/Head Office regularly.

(xii) The operation in each advance should be reviewed at least once every year.

(xiii) Post disbursement supervision and follow-up should be proper, such as receipt of stock statements, instalments, renewal of limits, etc.

(xiv) There should not be any misutilisation of the loans and instances indicative of diversion of funds should be checked.

(xv) Letters of credit issued by the branch should be within the delegated power and should be for genuine trade transactions.

(xvi) Bank guarantees issued, should be properly worded and recorded in the register of the bank. They should be promptly renewed on the due dates.

(xvii) Proper follow-up should be made for overdue bills of exchange.

(xviii) The classification of advances should be done as per RBI guidelines.

(xix) The submission of claims to DICGC and ECGC should be on time.

(xx) Instances of exceeding delegated powers should be promptly reported to controlling/Head Office by the branch and should be got confirmed or ratified at the required level.

Question 4

As a bank branch auditor, what aspects will be considered while reporting on credit appraisal, sanctioning /disbursement and documentation in respect of advances in the LFAR?

(5 Marks, November, 2011)

Answer

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.

Question 5

"An asset, including a leased asset, becomes non-performing when it ceases to generate income for the Bank." Define the criteria for classification of non-performing assets.

(8 Marks, May, 2011)

Answer

Classification of Non-Performing Assets: An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank.

Criteria for the classification of a Non Performing Asset (NPA) is a loan or an advance where-

(i) Interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan.

(ii) The account remains "out of order" in respect of an Overdraft/Cash Credit (OD/CC).

(iii) The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.

(iv) The instalments of principal or interest thereon remain overdue for two crop seasons for short duration crops.

(v) The instalment of principal or interest thereon remains overdue for one crop season for long duration crops.

(vi) The amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitization dated 1st February, 2006.

(vii) In respect of derivative transactions, the overdue receivables representing positive mark to Market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

Question 6

Write short notes on Reversal of Income under Bank Audit. *(5 Marks, November, 2010)*

Answer

Reversal of Income: 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).

Question 7

(a) While auditing the Branch of a Bank you are required to examine Inter Branch adjustments. Which points require your special attention? *(6 Marks, May, 2010)*

(b) How do you examine claims against the Bank not acknowledged as debts?

(4 Marks, May, 2010)

Answer

(a) Special points to examine Inter Branch adjustments: 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) Examination of claims against the Bank not acknowledged as debts: The auditor should examine the relevant evidence, for example correspondence with lawyers, claimants, workers/officers and workmen's/officer's unions. The auditor should also review the minutes of the meeting of the Board of directors/committees of the Board, contracts, agreements and arrangements, list of pending legal cases and correspondence relating to taxes, duties etc., to identify claims against the bank. The auditor should ascertain from the management the status of claims outstanding as at the end of previous year. A review of subsequent events would also provide evidence about completeness and valuation of claims.

Question 8

How will you evaluate the Internal Control system in the area of Credit Card operations of a Bank? *(5 Marks, November, 2009)*

Or

How will you evaluate the internal control system in the area of credit card operations in a bank? *(8 Marks, May, 2004)*

Answer

Evaluation of Internal Control System in the area of Credit Card Operations in a bank:

(i) There should be effective screening of applications with reasonably good credit assessments.

(ii) There should be strict control over storage and issue of cards.

(iii) There should be a system whereby a merchant confirms the status of unutilised limit of a credit-card holder from the bank before accepting the settlement in case the amount to be settled exceeds a specified percentage of the total limit of the card holder.

(iv) There should be system of prompt reporting by the merchants of all settlements accepted by them through credit cards.

(v) Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards.

(vi) All the reimbursements (gross of commission) should be immediately charged to the customer's account.

(vii) There should be a system to ensure that statements are sent regularly and promptly to the customer.

(viii) There should be a system of monitor and follow-up of customers' payments.

(ix) Items overdue beyond a reasonable period should be identified and attended to carefully. Credit should be stopped by informing the merchants through periodic bulletins, as early as possible, to avoid increased losses.

(x) There should be a system of periodic review of credit card holders' accounts. On this basis, the limits of customers may be revised, if necessary. The review should also include determination of doubtful amounts and the provisioning in respect thereof.

Question 9

(a) What do you understand by Long-form Audit Report? (2 Marks, November 2008)

(b) As the concurrent auditor of Nagpur Main Branch of XYZ Bank Ltd. state the issues which have to be considered in the audit of advances. (6 Marks, November, 2008)

Answer

(a) **Long form Audit Report:** The long form Audit Report has to be furnished by the auditor of a bank in addition to the audit report as per the statutory requirement. The matters which the banks require their auditor to deal with in the form of Long Form Audit Report have been specified by to Reserve Bank of India.

(b) **Audit of advances of a Bank:** The items to be covered in the concurrent audit of advances of a bank are as follows-

(i) Ensure that loans and advances are sanctioned properly.

(ii) Verify whether the sanctions are in accordance with the delegated authority.

(iii) Ensure that securities and documents have been received and properly charged/ registered.

(iv) Ensure that post disbursement supervision and follow up is proper.

(v) Verify whether there is any misuse of loans and advances and whether there are instances indicative of diversion of funds.

(vi) Check whether letters of credit issued by the branch are within the delegated power and ensure that they are genuine trade transactions.

(vii) Check bank guarantees issued are properly worked and recorded.

(viii) Ensure proper follow up of overdue bills of exchange.

(ix) Verify the classifications of advances are as per RBI directions.

(x) Verify whether the submission of claims to DICGC and ECGC is in time.

(xi) Verify the instances of exceeding delegated powers have been promptly reported.

(xii) Verify the frequency and genuineness of such exercise of authority beyond to delegated powers of the concerned officials.

Question 10

As a Statutory Auditor, how would you verify advances against Goods? (6 Marks, May, 2008)

Answer

Verification of advances against goods (Banking Companies):

(i) *Sanction:* Examine the sanction letter, letter of hypothecation and note the important terms and conditions of the advances.

(ii) *Stock statements:* Verify the quantity and value of goods hypothecated based on the stock statements received from the borrower. Test check the Godown Register and examine the valuation of goods to ascertain the reasonableness of the same.

(iii) *Inspection:* Ascertain as to whether the premises of the borrowers are periodically visited by the bank officials to verify the quantity as per the periodic stock statements.

(iv) *Stock Audit:* See whether the bank has got a system of obtaining stock and receivables audit report in respect of such advances. If so, review the stock audit report and identify adverse comments, if any.

(v) *Hypothecation/Pledge:* Examine the letter of hypothecation and certificate of registration of charge, in respect of goods pledged with the bank.

(vi) *Insurance:* Examine the insurance policies for their validity, adequacy etc. and see that policies are in favour of the bank.

(vii) *Documents of title:* Inspect the documents of title to goods like bill of lading, dock warrant, railway receipts etc to ensure that they are endorsed registered in favour of the bank.

(viii) *Third party certificate:* Where the hypothecated goods are in possession of third parties, such as clearing and forwarding agents, transporters, bankers, etc. undertaking has been obtained by the bank that they will handover the goods or sale proceeds thereof to the bank only. In such cases, certificate should be obtained by the bank from such third parties regarding quantities on hand, on balance sheet date. The valuation of such goods should be checked by the auditor.

Question 11

How would you verify "Acceptances, Endorsements and other obligations" appearing in the Balance Sheet of a bank? (6 Marks, May, 2007)

Answer

Acceptances, Endorsements and Other Obligations: This item includes the following balances-

(a) letters of credit opened by the bank on behalf of its customers and

(b) bills drawn by the bank's customers and accepted/endorsed by the bank.

Letters of credit: Evaluate the adequacy of the internal controls over LC Forms e.g. custody, maintenance of records, periodical verification, reconciliation etc.

Verify the balance of LC from the Register maintained by the bank to ascertain the amount of LC and payments made under them.

Examine the guarantees of the customers, copies of the LC issued & security obtained for issuing LC.

In respect of other acceptances and endorsements, the following procedure may be adopted-

(i) Examine the arrangements made by the bank with its customers.

(ii) Test check the amounts of bills with the register maintained by the bank.

(iii) Verify whether such bills are marked off in the register on payment at maturity.

Letters of comfort: Where letters of comfort has been issued, verify whether the bank has incurred a potential financial obligation under such a letter. If an obligation has been cast under letters of comfort, ensure that the amount has also been shown as contingent liability in the Balance Sheet.

Question 12

Explain the scope of concurrent audit of a bank with reference to Reserve Bank of India guidelines. (16 Marks, November, 2006)

Answer

Scope of concurrent audit of banks with reference to RBI guidelines: The following are the areas to be covered-

(i) Daily cash transactions with reference to abnormal receipts and payments. This will include currency chest transactions, major expenses met by cash, high value receipts and disbursements.

(ii) Purchase and sale of shares securities etc. Physical verification of investments and rates at which they are entered into.

(iii) Verification of procedure and documentation to open new current, savings, term deposit accounts, etc. Unusual operations noticed have to be thoroughly examined.

(iv) Verification of advances, overdrafts, temporary OD, Cash credit accounts, term loans, bills purchase, letters of credit etc. Procedure for sanction and documentation to be verified. Any deviation noticed to be examined in great detail.

(v) Foreign exchange transactions to be verified with reference to RBI guidelines.

(vi) Verification of balancing of all ledgers and registers, inter branch reconciliation calculation and verification of interest, discount, commission etc.

(vii) Revenue leakage to be detected.

(viii) Special efforts to be made in all fraud prone areas. The attempt should be to ensure that all effective measures are taken to prevent frauds.

(ix) Verification of high value transactions.

(x) Procedure for safe custody of security forms with the branch.

(xi) Whether all procedures for tax deduction at source are followed and the tax so deducted are deposited into Government Account within the time fixed.

(xii) Verification of returns, statements, calculation of capital adequacy ratio and compliance with requirements of government business.

(xiii) Study of RBI and Internal Inspection reports, statutory auditor's report and compliance thereto.

(xiv) Whether the customers' complaints are dealt with promptly.

Question 13

As a Statutory Auditor, of a bank, how would you verify the "Sacrifice" on Non-Performing Assets for which Corporate Debt Restructuring has been undertaken? (6 Marks, May, 2006)

Answer

Corporate Debt Restructuring and Sacrifice Element: The Revised Guidelines on Corporate Debt Restructuring (CDR) Mechanism specified that in case of rescheduling of accounts, the element of interest to be computed in present value terms. The guidelines state that the sacrifice should be computed as the difference between the present value of future interest income reckoned based on the current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring and the interest charged as per the restructuring package discounted by the current BPLR as on the date of restructuring plus appropriate term premium and credit risk premium as on the date of restructuring. Accordingly, the following steps may be taken in this regard-

(i) Check that the appropriate credit risk premium for the specific borrower category for all restructured accounts.

(ii) Ascertain appropriate rate of discount.

(iii) Check the computation of present value interest and the sacrifice amount.

(iv) See that the entire amount should be written off or provided for in case sacrifice is positive.

(v) Verify provision of adequate security coverage of the loan in case restructuring of principal amounts.

Question 14

Write short notes on Valuation of Investments "held to maturity" by banks.

(4 Marks, November, 2005)

Answer

Valuation of Investments "Held to Maturity": The banks are required to classify their entire investment portfolio into three categories: held to maturity (HTM), available for sale (AFS), and held for trading (HFT). Securities acquired with the intention to hold them up to maturity should be classified under HTM category. Thus, this category will comprise only debt securities (e.g., debentures, redeemable bonds, government securities), preference shares and similar securities having a defined period of maturity, except that equity shares of subsidiaries/joint ventures have also to be included in HTM category.

These investments need not be Marked to Market and will be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortized over the period remaining to maturity. For instance if a bond is acquired at say ₹ 90 and it is redeemable at ₹100 after three years, the discount, i.e., ₹10 should also be amortised as income over the next three years unless there is significant uncertainty of receipt of full face value on maturity.

Any diminution, other than temporary should be recognised in the value of their investments in subsidiaries/JVs and provided for. Such diminution should be determined and provided for each investment individually.

Question 15

What are the exceptions to the general rule of treating advances as Non-performing Assets (NPAs)? *(4 Marks, May, 2005)*

Answer

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.

(iiii) *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.

Question 16

Write short notes on Principal Enactments Governing Bank Audit. (4 Marks, November, 2004)

Answer

Principal Enactments Governing Bank Audit: There is an elaborate legal framework governing the functioning of banks in India. The principal enactments which govern the functioning of various types of banks are-

(i) Banking Regulation Act, 1949.

(ii) State Bank of India Act, 1955.

(iii) Companies Act, 2013.

(iv) State Bank of India (Subsidiary Banks) Act, 1959.

(v) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970.

(vi) Regional Rural Banks Act, 1976.

(vii) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.

(viii) Information Technology Act, 2000.

(ix) Prevention of Money Laundering Act, 2002.

(x) Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

(xi) Credit Information Companies Regulation Act, 2005.

(xii) Payment and Settlement Systems Act, 2007.

Besides, the above enactments, the provisions of the Reserve Bank of India Act, 1934, also affect the functioning of banks. The Act gives wide powers to the RBI to give directions to banks which also have considerable effect on the functioning of banks.

12

Audit of General Insurance Companies

Question 1

Write a short note on - Incoming and Outgoing Co-insurance.

Answer

Incoming and Outgoing Co-insurance: In cases of large risks, the business is shared between more than one insurer under co-insurance arrangements at agreed percentages. The leading insurer issues documents, collects premium and settles claims. Statement of accounts is rendered by the leading insurer to the other co-insurers. The auditor should verify incoming co-insurance and outgoing co-insurance as follows:

(i) ***Incoming Co-Insurance****:* The auditor should see that the Premium Account is credited on the basis of statements received from the leading insurer. In case, the statement is not received, the premium is accounted for on the basis of advices to ensure that all premium in respect of risks assumed in any year is booked in the same year. It would be advisable for the auditor to scrutinise the communication in the post-audit period and obtain a written confirmation to the effect that all incoming advices have been accounted for. The auditor should also verify claims provisions and claims paid with reference to advice received from the leading insurer.

(ii) ***Outgoing Co-Insurance****:* The auditor should scrutinise the transactions relating to the outgoing business, i.e. where the company is the leader. These should be checked with reference to the relevant risks assumed under policies and correspondingly for debits arising to the co-insurer on account of their share of claims.

Question 2

What are the steps to be taken while verifying the Premium of a General Insurance Company?

Answer

Verification of Premiums: Verification of premium is of utmost importance to an auditor. The auditor should apply, inter alia, the following procedures for verification of premium-

(i) Before commencing verification of premium income, the auditor should look into the internal controls and compliance thereof as laid down for collection and recording of the premiums.

(ii) The auditor should ascertain that all the cover notes relating to the risks assumed have been serially numbered for each class of business. The auditor should also verify that there is an adequate internal check on the issue of stationery comprising of cover notes, policy documents, stamps, etc. The auditor may apply sampling techniques for verification of larger volume of transactions.

(iii) The auditor should ensure that premium in respect of risks incepting during the relevant accounting year has been accounted as premium income of that year on the basis of premium revenue recognition. The auditor, as part of his audit procedures, should make an assessment of the reasonability of the risk pattern established by the management. The auditor should also see whether the premium received during the year but pertaining to risk commencing in the following year has been accounted for under the head 'Premium Received in Advance' and has been disclosed separately. Normally, such instances relate to the issue of cover notes and certificates at the end of the accounting year relating to risks commencing in the next accounting period. Generally, there is a column in the Premium Register called "Commencement of Risk", indicating the date and time from which the risk under the policy issued has commenced. The auditor should verify that policy documents have not been issued, or where issued, the company was not at risk, in case:

(a) premium had not been collected at all;

(b) premium had been collected but the relevant cheques have been dishonoured;

(c) premium had not immediately been collected due to furnishing of a bank guarantee or cash deposit but either the deposit or guarantee had fallen short or has expired or the premium had been collected beyond the stipulated time limit (i.e., there is a shortfall in bank guarantee account or cash deposit account of the insured);

(d) premium had not been collected due to risk cover being increased or where stipulated limits have been exhausted in respect of open declaration policies (i.e., where premium has accrued but has not been received); and

(e) instalments of premium have not been collected in time in respect of certain categories of policies, e.g., marine-cum-erection policies where facility has been granted for premium being paid in instalments (such facility is normally available subject to certain conditions, e.g., that the first equated instalment is more by 5 per cent of the total premium payable by instalments).

(iv) The auditor should examine whether the reinsurance company is not under a risk in respect of amount lying at credit and outstanding as at the year-end in the following accounts:

(a) Deposit Premium Account;

(b) Premium Received in Advance Account;

(c) Inspectors' Deposits Account; and

(d) Agent's Premium Accounts.

(v) The auditor should verify the collections lodged by agents after the balance sheet date to see whether any collection pertains to risk commencing for the year under audit. The

auditor should also check that the premium has been recorded originally at the gross figure, i.e., without providing for unexpired risks and reinsurances.

(vi) In case of co-insurance business, where the company is not the leader, because of the non-availability of the relevant information in many cases the premium is not booked even though the risk has commenced during the relevant accounting year. The auditor should see that the company's share of the premium has been accounted for on the basis of the available information on nature of risk and the provisional premium charged by the leading insurer. The auditor should examine the communications issued to the company by the leading insurers advising them of the company's share of premium income. Such communications should be seen even in respect of the post-audit period. Where the company is the leader, the auditor should obtain a reasonable assurance that only the company's own share of premium has been shown as income and accounts of the other companies have been credited with their share of the premium collected.

(vii) The auditor should check whether Premium Registers have been maintained chronologically, for each underwriting department, giving full particulars including service tax charged as per acceptance advice on a day-to-day basis. The auditor should verify whether the figures of premium mentioned in the register tally with those in General Ledger.

(viii) Where policies have been issued with a provision to collect premium periodically (i.e., under instalment clause, special declaration policy or periodical declaration under open policies in marine insurance), the auditor should check whether premia are collected as and when they become due.

(ix) The auditor should verify whether instalments falling due on or before the balance sheet date, whether received or not, have been accounted for as premium income as for the year under audit. Also examine whether instalments of premium falling due in the subsequent year have not been recognised in the accounts as outstanding premium.

(x) The auditor should verify the year end transactions to check that amounts received during the year in respect of risks commencing/ instalments falling due on or after the first day of next financial year are not credited to premium account but credited to Premium Received in Advance Account.

(xi) The auditor should verify the collections remitted by agents immediately after the cut-off date to verify the risk assumed during the year under audit on those collections.

(xii) The auditor should also check that in case of cancellation of policies/cover notes issued, no risk has been assumed between the date of issue and subsequent cancellation thereof.

(xiii) Where premium originally received has been refunded, the auditor should verify whether the agency commission paid on such premium has been recovered.

(xiv) The auditor should verify whether service tax has been charged from the insured, at the rates in force, on the total premium for all classes of business other than those exempted under service tax laws. Check whether service tax so collected is disclosed under 'Current Liabilities' to the extent not deposited in Government's Account.

(xv) In the case of co-insurance business, the auditor should verify whether service tax at the rates in force on the whole premium has been charged or collected from the insured by the company in case it is the leader.

Check that service tax so collected on premium charged trained from the insured by the company have been regularly deposited in the Government's Account.

Question 3

Enumerate the steps to be taken by an auditor for the verification of Re-insurance outward by a General Insurance Company.

Answer

Verification of Re-insurance outward: The following steps may be taken by the auditor in the verification of re-insurance outward-

(i) The auditor should verify that re-insurance underwriting returns received from the operating units regarding premium, claims paid, outstanding claims tally with the audited figures of premium, claims paid and outstanding claims.

(ii) The auditor should check whether the pattern of re-insurance underwriting for outward cessions fits within the parameters and guidelines applicable to the relevant year.

(iii) The auditor should also check whether the cessions have been made as per the stipulation applicable to various categories of risk.

(iv) The auditor should verify whether the cessions have been made as per the agreements entered into with various companies.

(v) It should also be seen whether the outward remittances to foreign re-insurers have been done as per the foreign exchange regulations.

(vi) It should also be seen whether the commission on cession has been calculated as per the terms of the agreement with the re-insurers.

(vii) The auditor should verify the computation of profit commission for various automatic treaty arrangements in the light of the periodical accounts rendered and in relation to outstanding loss pertaining to the treaty.

(viii) The auditor should examine whether the cash loss recoveries have been claimed and accounted on a regular basis.

(ix) The auditor should also verify whether the Claims Paid item appears in Outstanding Claims list by error. This can be verified at least in respect of major claims.

(x) He should see whether provisioning for outstanding losses recoverable on cessions have been confirmed by the re-insurers and in the case of major claims, documentary support should be insisted and verified.

(xi) Accounting aspects of the re-insurance cession premium, commission receivable, paid claims recovered, and outstanding losses recoverable on cessions have to be checked.

(xii) The auditor should check percentage pattern of gross to net premium, claims paid and outstanding claims to ensure comparative justification.

(xiii) The auditor should also check that the re-insurers balance on cessions and whether the sub ledger balances tallies with the general ledger balances.

(xiv) The auditor should review the individual accounts to find out whether any balance requires provisioning / write off or write back.

(xv) He should verify whether the balances with re-insurers are supported by necessary confirmation obtained from them.

(xvi) He should verify whether opening outstanding claims not paid during the year find place in the closing outstanding claims vis-a-vis the reinsurance inwards outstanding losses recoverable on cessions appears in both opening and closing list. If not, the reason for the same should be analysed.

(xvii) Any major event after the Balance Sheet date which might have wider impact with reference to subsequent changes regarding the claim recovery both paid and outstanding and also re-insurance balances will need to be brought out suitably.

Question 4

What are the specific areas to which you will give your attention while examining "Claims Paid" by a General Insurance Company.

Answer

Examination of claims paid in respect of a General Insurance Company: The auditor may determine the extent of checking of claims paid on the same line as suggested for outstanding claims. Other aspects in respect of claims paid to be examined by the auditors are as follows-

(i) that in case of co-insurance arrangements, claims paid have been booked only in respect of company's share and the balance has been debited to other insurance companies;

(ii) that in case of claims paid on the basis of advices from other insurance companies (where the company is not the leader in co-insurance arrangements), whether share of premium was also received by the company. Such claims which have been communicated after the year-end for losses which occurred prior to the year end must be accounted for in the year of audit;

(iii) that the claims payments have been duly sanctioned by the authority concerned and the payments of the amounts are duly acknowledged by the claimants;

(iv) that the salvage recovered has been duly accounted for in accordance with the procedure applicable to the company and a letter of subrogation has been obtained in accordance with the laid down procedure;

(v) that the amounts of the nature of pure advances/deposits with Courts, etc., in matters under litigation/arbitration have not been treated as claims paid but are held as assets till final disposal of such claims. In such cases, full provision should be made for outstanding claims;

(vi) that payment made against claims partially settled have been duly vouched. In such cases, the sanctioning authority should be the same as the one which has powers in respect of the total claimed amount;

(vii) that in case of final settlement of claims, the claimant has given an unqualified discharge note, not involving the company in any further liability in respect of the claim; and

(viii) that the figures of claims, wherever communicated for the year by the Division to the Head Office for purposes of reinsurance claims, have been reconciled with the trial balance-figure.

Question 5

State the procedure for verification of Agents' Balances in the course of audit of a General Insurance Company.

Answer

General Insurance Company – Verification of Agents' Balances: The following are the audit procedures for verification of outstanding agents' balances-

(i) Scrutiny and review of control accounts debit balances and their nature should be enquired into.

(ii) Examination of inoperative balances and treatment given for old balances shall be looked into.

(iii) Enquiring into the reasons for retaining the old balance.

(iv) Verification of old debit balances which may require provision or adjustment. Explanation shall be obtained from the management in this regard.

Question 6

"In an audit of an insurance company, the Receipts and Payments Account is also subjected to audit". Comment on this statement in brief.

Answer

Audit of Receipts and Payments Account: Section 11(1A) of the Insurance Act, 1938 provides that every insurer, in respect of insurance business transacted by him and in respect of his shareholders' funds, should prepare at the end of each financial year, a Balance Sheet, a Profit and Loss Account, a separate account of receipts and payments and a Revenue Account in accordance with the Regulations made by the IRDA. Since receipts and payments account has been made a part of financial statements of an insurer, it is implied that the receipts and payments account is also required to be audited.

The IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002 require that the auditor of an insurance company should:

(i) report whether the receipts and payments account of the insurer is in agreement with the books of account and returns;

(ii) express an opinion as to whether the receipts and payments account has been prepared in accordance with the provisions of the relevant statutes; and

(iii) express an opinion whether the receipts and payments account give a true and fair view of the receipts and payments of the insurer for the financial year/period under audit.

It may hence be said that auditor is required to audit the Receipts and Payments Account of the insurer and also express an opinion on the same.

Question 7

What are the steps to be taken by an auditor for the audit of re-insurance ceded?

Answer

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.

Question 8

Write a short note on - Solvency margin in case of an insurer carrying on general insurance business.

Answer

Solvency margin in case of an insurer carrying on general insurance business: Section 64VA of the Insurance Act, 1938, inter alia, requires every insurer to maintain an excess of the value of its assets over the amount of its liabilities at all times. The excess is known as 'Solvency Margin'. In the case of an insurer carrying on general insurance business, the solvency margin should be the highest of the following amounts:

(a) fifty crore rupees (one hundred crores of rupees in case of a reinsurer); or

(b) a sum equivalent to twenty percent of net premium income; or

(c) a sum equivalent to thirty percent of net incurred claims,

subject to credit for reinsurance in computing net premiums and net incurred claims being actual but a percentage, determined by the regulation but not exceeding fifty percent. It may be noted that conditions regarding maintenance of the above mentioned solvency margin may be relaxed by the Authority in certain special circumstances.

If, at any time, an insurer does not maintain the required solvency margin, the insurer is required to submit a financial plan to the Authority indicating the plan of action to correct the deficiency in the solvency margin. If, on consideration of the plan, the Authority finds it inadequate, the insurer has to modify the financial plan.

Maintenance of solvency margin has a great importance for an insurance company considering their size and nature of business and also involvement of public money. Sub-section (2C) of Section 64A states that if an insurer fails to comply with the requirements of the Insurance Act, 1938, it shall deemed to be insolvent and may be wound up by the Court.

Question 9

Write a short note on - Facultative reinsurance under Insurance Act, 1938.

Answer

Facultative Reinsurance: It is that type of reinsurance whereby the contract relates to one particular risk and is expressed in the reinsurance policy. This is the oldest method of reinsurance and it necessitates consideration of each risk separately. Each transaction under facultative reinsurance has to be negotiated individually. Each party to the transaction has a free choice, i.e., for the ceding company to offer and the reinsurer to accept. The main drawbacks of this type of insurance are the volume of work involved and time taken to cover the risk. It is, however, still used even today, mainly when:

(i) automatic covers have already been exhausted.

(ii) the risk is excluded from the Treaties.

(iii) the insurer does not want his reinsurance treaties overburdened with particularly heavy and abnormal risks.

(iv) the insurer has no automatic cover at his disposal in a particular branch, where he issues policies rarely.

(v) the nature of business is such that technical guidance or consultation with the reinsurer is required at every stage of acceptance of the risk itself or for a type of business where the number of risks is very small, for example, in atomic energy installations, oils rigs, etc.

Question 10

As the auditor of an Insurance company state the audit procedure you would follow to verify outstanding premium and agents balances.

Answer

"Outstanding Premium and Agents Balances" in the case of Insurance company: The following are the audit procedure to be followed for verification of outstanding premium and agents balances in the case of Insurance Company-

(i) Scrutinise and review control account debit balances and their nature should be enquired into.

(ii) Examine in operative balances and treatment given for old balances with reference to company rules.

(iii) Enquire the reasons for returning the old balances.

(iv) Verify old debit balances which may require provision or adjustment. Notes of explanation may be obtained from the management in this regard.

(v) Check age-wise, sector-wise analysis of outstanding premium.

(vi) Verify whether outstanding premiums have since been collected.

(vii) Check the availability of adequate bank guarantee or premium deposit for outstanding premium.

Question 11

State the disclosure requirements in respect of contingent liabilities in the notes to the Balance Sheet of a General Insurance Company.

Answer

Disclosure requirements in respect of contingent liabilities in the notes to the Balance Sheet of a General Insurance Company: The following shall be disclosed by way of notes to balance sheet in respect of Contingent Liabilities-

(i) Partly paid up investments.

(ii) Underwriting Commitments outstanding.

(iii) Claims, other than those under policies, not acknowledged as debts.

(iv) Guarantees given by or on behalf of the Company.

(v) Statutory demands/Liabilities in dispute, not provided for.

(vi) Reinsurance obligations to the extent not provided for in the accounts.

(vii) Others (to be specified).

Question 12

As at 31st March 2014 while auditing Safe Insurance Ltd, you observed that a policy has been issued on 25th March 2014 for fire risk favouring one of the leading corporate houses in the country without the actual receipt of premium and it was reflected as premium receivable. The company maintained that it is a usual practice in respect of big customers and the money was collected on 5th April, 2014. You further noticed that there was a fire accident in the premises of the insured on 31st March 2014 and a claim was lodged for the same. The insurance company also made a provision for claim. Please respond.

Answer

Provision for claim: No risk can be assumed by the insurer unless the premium is received. According to section 64VB of the Insurance Act, 1938, no insurer should assume any risk in India in respect of any insurance business on which premium is ordinarily payable in India unless and until the premium payable is received or is guaranteed to be paid by such person in such manner and within such time, as may be prescribed, or unless and until deposit of such amount, as may be prescribed, is made in advance in the prescribed manner. The premium receipt of insurance companies carrying on general insurance business normally arise out of three sources, viz., premium received from direct business, premium received from reinsurance business and the share of co-insurance premium.

In view of the above, the insurance company is not liable to pay the claim and hence no provision for claim is required.

Question 13

ABC Limited, an Indian insurance company carrying on general insurance business, is facing liquidity problems and, therefore, it has decided to maintain deposits under section 7 of the Insurance Act, 1938 at one percent of total gross premium written in India. The company thinks that it is sufficient, as the company has a Paid-up Capital of ₹ 150 Crores. As an Auditor of ABC Limited what would be your suggestion to the company for compliance of Insurance Act and rules and regulations made there under?

Answer

Maintaining deposits under section 7 of the Insurance Act, 1938: Section 7 of the Insurance Act, 1938 requires every insurer, carrying a general insurance business, to deposit and keep deposited with RBI in it's one of the offices in India a sum equivalent to three percent of total gross premium written in India in any financial year. The maximum limit of deposit under this section is Rupees ten crores. The deposit is to be for and on behalf of the Government of India. The deposit can be made either by way of

cash or investment in approved securities. If securities are deposited, their estimated market value on the date of deposit is to be seen. The amount of deposit required in the case of reinsurance business is rupees twenty crores.

In the given case, Since ABC Limited has decided to maintain deposits at one percent of the total gross premium written in India, which is violation of the Section 7 of the Insurance Act, 1938. The contention of the company that it has a paid up capital of ₹ 150 Crores would not make the difference.

Question 14

RQ Insurance Ltd. has made a provision of 25% on unexpired risks reserve in its books. Comment.

Answer

Unexpired risks reserve: The need for unexpired risks reserve arises from the fact that all policies are renewed annually except in specific cases where short period policies are issued. Since the insurers close their accounts on a particular date, not all risks under policies expire on that date.

In other words at the closing date, there is an unexpired liability under various policies which may occur during the remaining term of the policy beyond the year end.

The minimum amount of unexpired risks reserve to be created is determined as per the Insurance Act, 1938 at a specified percentage of net premium as under:

(i) for marine hull insurance – 100% of net premium

(ii) For fire, marine cargo and miscellaneous business – 50% of net premium.

Provisions of Income Tax Act 1961 and Income Tax rules 1962 permit deduction of above reserves at the prescribed rates.

Conclusion: In the given case, the Auditor of RQ Insurance Ltd should qualify his report as the company has made a provision of only 25% against the prescribed minimum of 50% or 100% as mentioned above, thereby resulting in overstatement of profit.

Question 15

State the procedure to determine the value of listed and unlisted equity securities and derivative instruments of an insurance company.

Answer

Procedure to determine the value of listed and unlisted equity securities and derivative instruments of an insurance company: Equity securities and derivative instruments that are traded in active markets, shall be measured at fair value as at the Balance Sheet date. Fair value will be the lowest of the last quoted closing price of the stock exchanges where the securities are listed. The insurance company shall assess on each Balance Sheet date whether any impairment of listed security/derivative instruments has occurred.

An active market shall mean a market, where the securities traded are homogeneous, availability of willing buyers and sellers is normal and the prices are publicly available.

Unrealized gains/losses arising due to changes in fair value of listed equity shares and derivative instruments shall be taken to equity under the head 'Fair Value Change Account'. The 'profit' on sale of investments' or 'loss on sale of investments', as the case may be, shall include accumulated changes in the fair value previously recognized in equity under the heading Fair Value Change Account in respect of particular security and being recycled to profit and loss account on actual sale of that listed security.

Any credit balance in Fair Value Change Account will not be available for distribution as dividends. Also any debit balance in such an account shall be reduced from profits/free reserves while declaring dividends.

At every Balance Sheet date, impairment loss should be recognized as an expense to the extent of the difference between the re-measured fair value of the security and its acquisition cost as reduced by any previous impairment loss already recognized. Any reversal of impairment loss earlier recognized as an expense, should be recognized in the Revenue/Profit & Loss Account.

Unlisted and other than actively traded equity securities and derivative instruments will be measured at historical costs. Provision shall be made for diminution in value of such investments. Provision shall be made for diminution in value of such investments. The provision so made shall be reversed in subsequent periods if estimates based on external evidence show an increase in the value of investments over its carrying amount. The increased carrying amount of the investments due to reversal of the provision shall not exceed the historical cost.

12

Audit of General Insurance Companies

Question 1

ABC Limited, an Indian insurance company carrying on general insurance business, is facing liquidity problems and, therefore, it has decided to maintain deposits under section 7 of the Insurance Act, 1938 at one percent of total gross premium written in India. The company thinks that it is sufficient, as the company has a Paid-up Capital of ₹ 150 Crores. As an Auditor of ABC Limited what would be your suggestion to the company for compliance of Insurance Act and rules and regulations made there under? (4 Marks, November, 2013)

Answer

Maintaining deposits under section 7 of the Insurance Act, 1938: Section 7 of the Insurance Act, 1938 requires every insurer, carrying a general insurance business, to deposit and keep deposited with RBI in it's one of the offices in India a sum equivalent to three percent of total gross premium written in India in any financial year. The maximum limit of deposit under this section is Rupees ten crores. The deposit is to be for and on behalf of the Government of India. The deposit can be made either by way of cash or investment in approved securities. If securities are deposited, their estimated market value on the date of deposit is to be seen. The amount of deposit required in the case of reinsurance business is rupees twenty crores.

In the given case, Since ABC Limited has decided to maintain deposits at one percent of the total gross premium written in India, which is violation of the Section 7 of the Insurance Act, 1938. The contention of the company that it has a paid up capital of ₹ 150 Crores would not make the difference.

Question 2

As at 31st March 2013 while auditing Safe Insurance Ltd you observed that a policy has been issued on 25th March 2013 for fire risk favouring one of the leading corporate houses in the country without the actual receipt of premium and it was reflected as premium receivable. The company maintained that it is a usual practice in respect of big customers and the money was collected on 5th April, 2013. You further noticed that there was a fire accident in the premises of the insured on 31st March 2013 and a claim was lodged for the same. The insurance company also made a provision for claim. Please respond.

(4 Marks, May, 2013)

Answer

Provision for Claim: No risk can be assumed by the insurer unless the premium is received. According to section 64VB of the Insurance Act, 1938, no insurer should assume any risk in India in respect of any insurance business on which premium is ordinarily payable in India unless and until the premium payable is received or is guaranteed to be paid by such person in such manner and within such time, as may be prescribed, or unless and until deposit of such amount, as may be prescribed, is made in advance in the prescribed manner. The premium receipt of insurance companies carrying on general insurance business normally arise out of three sources, viz., premium received from direct business, premium received from reinsurance business and the share of co-insurance premium.

In view of the above, the insurance company is not liable to pay the claim and hence no provision for claim is required.

Question 3

Write short notes on Solvency Margin. (4 Marks, May, 2012)

Or

Write short notes on Solvency margin in case of an insurer carrying on general insurance business. (4 Marks, November, 2006)

Answer

Solvency Margin: Section 64VA of the Insurance Act, 1938, inter alia, requires every insurer to maintain an excess of the value of its assets over the amount of its liabilities at all times. The excess is known as 'Solvency Margin'. In the case of an insurer carrying on general insurance business, the solvency margin should be the highest of the following amounts:

(a) fifty crore rupees (one hundred crores of rupees in case of a reinsurer); or

(b) a sum equivalent to twenty percent of net premium income; or

(c) a sum equivalent to thirty percent of net incurred claims,

subject to credit for reinsurance in computing net premiums and net incurred claims being actual but a percentage, determined by the regulation but not exceeding fifty percent. It may be noted that conditions regarding maintenance of the above mentioned solvency margin may be relaxed by the Authority in certain special circumstances.

If, at any time, an insurer does not maintain the required solvency margin, the insurer is required to submit a financial plan to the Authority indicating the plan of action to correct the deficiency in the solvency margin. If, on consideration of the plan, the Authority finds it inadequate, the insurer has to modify the financial plan.

Maintenance of solvency margin has a great importance for an insurance company considering their size and nature of business and also involvement of public money. Sub-section (2C) of Section 64A states that if an insurer fails to comply with the requirements of the Insurance Act, 1938, it shall deemed to be insolvent and may be wound up by the Court.

Question 4

Write short notes on Audit procedure in respect of "Outstanding premium and Agents balance" in Insurance company. (4 Marks, November, 2011)

Or

Write short notes on Guidance note on Verification of Outstanding Premium and Agents' Balances. (5 Marks, November, 2010)

Or

As the auditor of an Insurance company state the audit procedure you would follow to verify outstanding premium and agents balances. (4 Marks, November, 2008)

Or

State the procedure for verification of Agents' Balances in the course of audit of a General Insurance Company. (4 Marks, November, 2004)

Answer

"Outstanding Premium and Agents Balances" in the case of Insurance company: The following are the audit procedures to be followed for verification of outstanding premium and agents' balances:

(i) Scrutinise and review control account debit balances and their nature should be enquired into.

(ii) Examine inoperative balances and treatment given for old balances with reference to company rules.

(iii) Enquire into the reasons for retaining the old balances.

(iv) Verify old debit balances which may require provision or adjustment. Notes of explanation may be obtained from the management in this regard.

(v) Check age-wise, sector-wise analysis of outstanding premium.

(vi) Verify whether outstanding premiums have since been collected.

(vii) Check the availability of adequate bank guarantee or premium deposit for outstanding premium.

Question 5

State the disclosure requirements in respect of contingent liabilities in the notes to the Balance Sheet of a General Insurance Company. (4 Marks, May, 2011)

Answer

Disclosure requirements in respect of contingent liabilities in the notes to the Balance Sheet of a General Insurance Company: The following shall be disclosed by way of notes to balance sheet in respect of Contingent Liabilities.

(i) Partly paid up investments.

(ii) Underwriting Commitments outstanding.

(iii) Claims, other than those under policies, not acknowledged as debts.

(iv) Guarantees given by or on behalf of the Company.

(v) Statutory demands/liabilities in dispute, not provided for.

(vi) Reinsurance obligations to the extent not provided for in the accounts.

(vii) Others (to be specified).

Question 6

While auditing the claims paid in respect of a General Insurance Company what aspects need to be looked into? (6 Marks, May, 2010)

Or

What are the specific areas to which you will give your attention while examining "Claims Paid" by a General Insurance Company. (8 Marks, May, 2004)

Answer

Audit of the claims paid in respect of a General Insurance Company: The following are the aspects needs to be examined in respect of claims paid:

(i) In case of co-insurance arrangements, claims paid have been booked only in respect of the company's share and the balance has been debited to other insurance companies;

(ii) In case of claims paid on the advices from other insurance companies, (where the company is not the leader in co-insurance arrangements), whether share of premium was also received by the Company. Such claims which have been communicated after the year end for losses which occurred prior to the year end must be accounted for in the year of audit;

(iii) Claims paid have been duly authorized and acknowledged by the claimants;

(iv) Salvage recovery has been in accordance with the procedure prescribed and a letter of subrogation has been obtained in accordance with the laid down procedure;

(v) That the amounts of the nature of pure advances/deposits with Courts, etc., in matters under litigation/arbitration have not been treated as claims paid but are held as assets till final disposal of such claims. In such cases, full provision should be made for outstanding claims;

(vi) That payment made against claims partially settled has been duly vouched. In such cases, the sanctioning authority should be the same as the one which has powers in respect of the total claimed amount;

(vii) In case of final settlement of claims, the claimant has given unqualified discharge note, not involving the company in any further liability in respect of the claim; and

(viii) That the figures of claims, wherever communicated for the year by the Division to the Head Office for purposes of reinsurance claims, have been reconciled with the trial balance-figure.

Question 7

Enumerate the steps to be taken by an auditor for the verification of Re-insurance outward in case of a General Insurance Company. (5 Marks, November, 2009)

Answer

Steps under sub-regulation 4 of the IRDA (General Insurance – Re-insurance) Regulations, 2000:

(i) The auditor should verify that re-insurance underwriting returns received from the operating units regarding premium, claims paid, outstanding claims tally with the audited figures of premium, claims paid and outstanding claims.

(ii) The auditor should check whether the pattern of reinsurance underwriting for outward cessions fits within the parameters and guidelines applicable to the relevant year.

(iii) The auditor should also check whether the cessions have been made as per the stipulation applicable to various categories of risk.

(iv) The auditor should verify whether the cessions have been made as per the agreements entered into with various companies.

(v) It should also be seen whether the outward remittances to foreign re-insurers have been done as per the foreign exchange regulations.

(vi) It should also be seen whether the on cessions have been calculated as per the terms of the agreements with the re-insurers.

(vii) The auditor should verify the computation of profit commission for various automatic treaty arrangements in the light of the periodical accounts rendered and in relation to outstanding loss pertaining to the treaty.

(viii) The auditor should examine whether the cash loss recoveries have been claimed and accounted on a regular basis.

(ix) The auditor should also verify whether the claims paid item appears in outstanding claims list by error. This can be verified at least in respect of major claims.

(x) He should see whether provisioning for outstanding losses recoverable on cessions have been confirmed by the re-insurers and in the case of major claims, documentary support should be insisted and verified.

(xi) Accounting aspects of the re-insurance cession premium, commission receivable, paid claims recovered, and outstanding losses recoverable on cessions have to be checked.

(xii) The auditor should check percentage pattern of gross to net premium, claims paid and outstanding claims to ensure comparative justification.

(xiii) The auditor should also check that the re-insurers balance on cessions and whether the sub ledge balances tallies with the general ledger balance.

(xiv) The auditor should review the individual accounts to find out whether any balance requires provisioning/write off or write back.

(xv) He should verify whether the balances with re-insurers are supported by necessary confirmation obtained from them.

(xvi) He should verify whether opening outstanding claims not paid during the year find place in the closing outstanding claims vis-avis the reinsurance inwards outstanding losses recoverable on cessions appears in both opening and closing list. If not, the reason for the same should be analysed.

(xvii) Any major event after the balance sheet date which might have wider impact with reference to subsequent changes regarding the claim recovery both paid and outstanding and also re-insurance balances will need to be brought out suitably.

Question 8

RQ Insurance Ltd. has made a provision of 25% on unexpired risks reserve in its books. Comment. (5 Marks, May, 2008)

Answer

Unexpired risks reserve: The need for unexpired risks reserve arises from the fact that all policies are renewed annually except in specific cases where short period policies are issued. Since the insurers close their accounts on a particular date, not all risks under policies expire on that date.

In other words at the closing date, there is an unexpired liability under various policies which may occur during the remaining term of the policy beyond the year end.

The minimum amount of unexpired risks reserve to be created is determined as per the Insurance Act, 1938 at a specified percentage of net premium as under:

(i) for marine hull insurance – 100% of net premium

(ii) For fire, marine cargo and miscellaneous business – 50% of net premium.

Provisions of income Tax Act 1961 and Income Tax rules 1962 permit deduction of above reserves at the prescribed rates.

Conclusion: In the given case, the Auditor of RQ Insurance Ltd should qualify his report as the company has made a provision of only 25% against the prescribed minimum of 50% or 100% as mentioned above, thereby resulting in overstatement of profit.

Question 9

State the procedure to determine the value of listed and unlisted equity securities and derivative instruments of an insurance company. (10 Marks, May, 2007)

Answer

Procedure to determine the value of listed and unlisted equity securities and derivative instruments of an insurance company: Equity securities and derivative instruments that are traded in active markets, shall be measured at fair value as at the Balance Sheet date. Fair value will be the lowest of the last quoted closing price of the stock exchanges where the securities are listed. The insurance company shall assess on each Balance Sheet date whether any impairment of listed security/derivative instruments has occurred.

An active market shall mean a market, where the securities traded are homogeneous, availability of willing buyers and sellers is normal and the prices are publicly available.

Unrealized gains/losses arising due to changes in fair value of listed equity shares and derivative instruments shall be taken to equity under the head 'Fair Value Change Account'. The 'profit' on sale of investments' or 'loss on sale of investments', as the case may be, shall include accumulated changes in the fair value previously recognized in equity under the heading Fair Value Change Account in respect of particular security and being recycled to profit and loss account on actual sale of that listed security.

Any credit balance in Fair Value Change Account will not be available for distribution as dividends. Also any debit balance in such an account shall be reduced from profits/free reserves while declaring dividends.

At every Balance Sheet date, impairment loss should be recognized as an expense to the extent of the difference between the re-measured fair value of the security and its acquisition cost as reduced by any previous impairment loss already recognized. Any reversal of impairment loss earlier recognized as an expense, should be recognized in the Revenue/Profit & Loss Account.

Unlisted and other than actively traded equity securities and derivative instruments will be measured at historical costs. Provision shall be made for diminution in value of such investments. Provision shall be made for diminution in value of such investments. The provision so made shall be reversed in subsequent periods if estimates based on external evidence show an increase in the value of investments over its carrying amount. The increased carrying amount of the investments due to reversal of the provision shall not exceed the historical cost.

Question 10

What are the steps to be taken by an auditor for the audit of re-insurance ceded?

(8 Marks, November, 2005)

Answer

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.

Question 11

"In an audit of an insurance company, the Receipts and Payments Account is also subjected to audit". Comment on this statement in brief. *(6 Marks, May, 2005)*

Answer

Audit of Receipts and Payments Account: Section 11(1A) of the Insurance Act, 1938 provides that every insurer, in respect of insurance business transacted by him and in respect of his shareholders' funds, should prepare at the end of each financial year, a Balance Sheet, a Profit and Loss Account, a separate account of receipts and payments and a Revenue Account in accordance with the Regulations made by the IRDA. Since receipts and payments account has been made a part of financial statements of an insurer, it is implied that the receipts and payments account is also required to be audited.

The IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002 require that the auditor of an insurance company should:

(i) report whether the receipts and payments account of the insurer is in agreement with the books of account and returns;

(ii) express an opinion as to whether the receipts and payments account has been prepared in accordance with the provisions of the relevant statutes; and

(iii) express an opinion whether the receipts and payments account give a true and fair view of the receipts and payments of the insurer for the financial year/period under audit.

It may hence be said that auditor is required to audit the Receipts and Payments Account of the insurer and also express an opinion on the same.

13

Audit of Co-operative Societies

Question 1

An auditor of a Co-operative 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.

Answer

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.

Question 2

Mention the duties of Auditor of Co-operative Societies in regard to the following:

(i) Over-due interest.

(ii) Compliance with provisions of Co-operative Act and Rules thereunder.

(iii) Special Report to Registrar of Co-operative Societies.

Answer

(i) Overdue interest: Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue. In practice an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.

(ii) Compliance with provisions of the Act and Rules: An auditor of a co-operative society is required to point out the infringement with the provisions of the relevant Co-operative Act Rules and bye-laws. The auditor of a co-operative society is also required to point out various irregularities, improprieties, and departure from the provision of the Act, rules framed thereunder and the bye-laws of the society. The financial implications of such infringements should be properly assessed and quantified by the auditor and they should be reported. Some of the State laws contain restrictions on the payment of dividends, which should be noted by the auditor and if dividend is declared in excess of the prescribed percentage, the fact should be reported by the auditor. Auditor should also ensure that various provisions in the Co-operative Societies Act, such as, restriction on borrowings, investment of funds, contribution to education funds, restriction on loans, etc. are also complied with.

(iii) Special Report to the Registrar: The auditors are required to report on number of matters as prescribed in various states. In addition to the main report, the auditors are also required to submit by way of schedules/audit memorandum information on the working of the company as well. 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:

(a) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.

(b) Detection of fraud relating to expenses, purchases, property and stores of the society.

(c) Specific examples of mis-management. Decisions of management against co-operative principles.

(d) 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.

Question 3

State the special features of Co-operative Societies Audit.

Answer

Special features of Co-operative Societies Audit: The special features of co-operative societies audit, to be borne in mind in general while conducting the audit are as follows-

(i) **Examination of overdue debts:** Overdue debts for a period from six months to five years and more than five years will have to be classified and shall have to be reported by an auditor. Overdue debts have far reaching consequences on the working of a credit society. It affects its working capital position. A further analysis of these overdue debts from the viewpoint of chances of recovery will have to be made, and they will have to be classified as good or bad. The auditor will have to ascertain whether proper provisions for doubtful debts are made and whether the same is satisfactory. The percentage of overdue debts to the working capital and loans advanced will have to be compared with last year, so as to see whether the trend is increasing or decreasing whether due and proper actions for recovery are taken, the position regarding cases in co-operative courts, District Courts etc. and the results thereof.

(ii) **Overdue Interest:** Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue. In practice an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.

(iii) **Certification of Bad Debts:** A peculiar feature regarding the writing off of the bad debts as per Maharashtra State Co-operative Rules, 1961, is very interesting to note. As per Rule No. 49, bad debts can be written off only when they are certified as bad by the auditor. Bad debts and irrecoverable losses before being written off against Bad Debts Funds, Reserve Fund etc. should be certified as bad debts or irrecoverable losses by the auditor where the law so requires. Where no such requirement exists, the managing committee of the society must authorise the write-off.

(iv) **Valuation of Assets and Liabilities:** Regarding valuation of assets there are no specific provisions or instructions under the Act and Rules and as such due regard shall be had to the general principles of accounting and auditing conventions and standards adopted. The auditor will have to ascertain existence, ownership and valuation of assets. Fixed assets should be valued at cost less adequate provision for depreciation. The incidental expenses incurred in the acquisition and the installation expenses of assets should be properly capitalised. If the difference in the original cost of acquisition and the present market price is of far reaching significance, a note regarding the present market value may be appended; so as to have a proper disclosure in the light of present inflatory conditions. The current assets should be valued at cost or market price, whichever is lower. Regarding the liabilities, the auditor should see that all the known liabilities are brought into the account, and the contingent liabilities are stated by way of a note.

(v) **Adherence to Co-operative Principles:** The auditor will have to ascertain in general, how far the objects, for which the co-operative organisation is set up, have been achieved in the course of its working. The assessment is not necessarily in terms of profits, but in terms of extending of benefits to members who have formed the society. Considered from the viewpoint of social benefits it may be looked into that how far the sales could be effected at lower prices. For the achievement of these activities, cost accounting methods, store control methods, techniques of standard costing, budgetary control etc. should be adopted. However, these modern techniques are mostly not in application and as such in practice a wide gap is found in the goals to be achieved and the actual achievements. While auditing the expenses, the auditor should see that they are economically incurred and there is no wastage of funds. Middlemen commissions are, as far as possible, avoided and the purchases are made by the committee members directly from the wholesalers. The principles of propriety audit should be followed for the purpose.

(vi) **Observations of the Provisions of the Act and Rules:** An auditor of a co-operative society is required to point out the infringement with the provisions of Co-operative Societies Act and Rules and bye-laws. The financial implications of such infringements should be properly assessed by the auditor and they should be reported. Some of the State Acts contain restrictions on payment of dividends, which should be noted by the auditor.

(vii) **Verification of Members' Register and examination of their pass books:** Examination of entries in members pass books regarding the loan given and its repayments, and confirmation of loan balances in person is very much important in a co-operative organisation to assure that the entries in the books of accounts are free from manipulation. Specifically in the rural and agricultural credit societies, members are not literate and as such this is a good safeguard on their part. Of course this checking will be resorted to on a test basis, which is a matter of judgement of the auditor.

(viii) **Special report to the Registrar:** 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:

(a) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.

(b) Detection of fraud relating to expenses, purchases, property and stores of the society.

(c) Specific examples of mis-management like decisions of management against co-operative principles.

(d) 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.

(ix) **Audit classification of society:** After a judgement of an overall performance of the society, the auditor has to award a class to the society. This judgement is to be based on the criteria specified by the Registrar. It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification. The auditor should be very careful, while making a decision about the class of society.

(x) **Discussion of draft audit report with managing committee:** On conclusion of the audit, the auditor should ask the Secretary of the society to convene the managing committee meeting to discuss the audit draft report. The audit report should never be finalised without discussion with the managing committee. Minor irregularities may be got settled and rectified. Matters of policy should be discussed in detail.

Question 4

Under what circumstances, an auditor is required to submit a special report to the registrar of Co-operative Societies?

Answer

Special Report by Auditor to Registrar of Co-operative Societies: Under the following circumstances, an auditor has to issue special report to the Registrar of Co-operative Societies (This report should be in addition to the regular report)-

(i) (a) Any member of the managing committee is involved in personal profit making by using the properties or assets of the society, resulting into the loss to the society.

(b) Frauds are detected from the society's transactions.

(ii) There is mismanagement in the society and the principles of co-operative are not maintained by the management.

(iii) In the respect of audit of Urban Co-operative Banks, disproportionate advances to vested interest groups. Such as relative 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.

Question 5

"Examination of overdue debts, audit classification of society, and reporting the infringement of provisions of the Act are the special features of audit of a co-operative society." Do you agree?

Answer

Special Features of Co-operative Society Audit: The special features of co-operative society audit, to be borne in mind in general while conducting the audit are examination of overdue debts, overdue Interest, certification of bad debts, valuation of assets and liabilities, adherence to co-operative principles, reporting infringement of act and rules, verification of members' register and examination of their pass books, special report to the registrar, audit classification of co-operative society, discussion of draft audit report with managing committee etc.

Besides the other special features mentioned above the Examination of overdue debts, audit classification of society and reporting the infringement of provisions of the Act, are some of special features of audit of a co-operative society which are explained as follows:

(i) **Examination of overdue debts**: Auditor of a co-operative society has to classify the overdue debts for a period from 6 months to five years and more than 5 years. Further these debts are to be analyzed in 'good' or 'bad' depending on the recoverability of the debts. The bad and doubtful debts require some provision and the auditor has to ascertain whether proper provision for bad & doubtful debts has been made. The current year's amount of overdue debts and its ratio to the working capital and loans outstanding is to be compared with last year to know whether the trend is increasing or decreasing. The status of the court cases for recovery of the overdue debts is also to be mentioned in the audit report. While calculating the profit the interest on the overdue debts is not to be taken into account. The Bad debts portion of the overdue debts is to be certified by the auditor for the purpose of writing off.

(ii) **Audit Classification of Co-operative Society**: It is a unique feature of the Co-operative audit. After completion of the audit the auditor has to evaluate the working of the society on the basis of various parameters and criteria which are specified by the Registrar. It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification. The auditor should be very careful, while making a decision about the class of society. For good performance having certain marks "A class is given. The D class is given to the society which shows very poor performance. In the same way B or C class is awarded on the basis of the marks obtained by the society.

(iii) **Reporting infringement of Act and Rules**: The auditor of the co-operative Society is required to report the non compliance of the various provisions of the Co-operative Societies Act, Rules framed under that Act and the by laws of the society. He has to assess the financial implications of such infringements and disclose the same in his report. The infringements of serious nature are to be reported separately and infringements which do not have financial implications and which have no serious effect on the working of the society or rights of the members may be reported separately.

Thus we can say that Examination of overdue debts, audit classification of society and reporting the infringement of provisions of the Act, are only some of special features of audit of a co-operative society.

Question 6

State the requirements regarding the maintenance of books of accounts with respect to a multi-state co-operative society.

Answer

Maintenance of Books of Accounts with respect to a Multi-State Co-Operative Society: As per the Multi State Co-operative Society Rules, 2002, every multi state co-operative society shall keep books of accounts with respect to-

(i) all sum of money received and expended and the matters in respect of which the receipt and expenditure took place.

(ii) all sales and purchases of goods.

(iii) the assets and liabilities of the society.

(iv) in the case of Multi State Co-operative Society engaged in production, processing and manufacturing particulars relating to utilization of materials or labour or other term of cost as may be specified in the bye laws of such a society.

Comprehensively, the following books of accounts may be maintained:

(i) **Cash book:** It may be maintained to record particulars regarding cash receipts and expenses under suitable heads, with clear distinction between capital and revenue items of receipts and expenses.

(ii) **Stock register:** It may contain detailed information as regards receipts, issues and balances of stock-in-trade, date-wise. In a producers co-operative society, perpetual inventory records may be maintained based on an appropriate costing method.

(iii) **Register of assets and investments:** It will contain detailed particulars regarding the various immovable and movable assets belonging to the society, such as, types of assets, location, date of acquisition, cost, depreciation provided, and so on.

(iv) **Register of fixed deposits:** In the case of a co-operative credit society, or a co-operative bank, or any other society which is authorised by its laws to accept deposits from members/ non-members, a register of fixed deposits may be maintained giving details as regards the dates of acceptance, maturity, interest accrual, repayment, etc.

(v) **Register of sureties:** In the case of a co-operative credit society, loans are given against personal security of members as also surety (guarantee) provided by two other members. The Register of Sureties will give particulars about the number of borrowers in respect of which a member has stood surety, and show whether it is within the overall limit of surety-ship that may be given by a member as prescribed by the bye-laws.

(vi) **Register of loan disbursement and recovery:** In the ease of a co-operative credit society, this Register will provide particulars regarding loans sanctioned by the society, the dates of disbursement and recovery.

Question 7

Write short notes on - Restrictions on investments of funds of a central co-operative society.

Answer

Restrictions on Investment of funds of a Central Cooperative Society: Provisions of the Central Act put some restrictions on investments of funds of a Central Cooperative Society. According to Section 32 of the Central Act, a Central Cooperative Society may invest its funds only in any one or more of the following:

(i) In the Central or State Co-operative Bank.

(ii) In any of the securities specified in Section 20 of the Indian Trusts Act, 1882.

(iii) In the shares, securities, bonds or debentures of any other society with limited liability.

(iv) In any co-operative bank, other than a Central or State co-operative bank, as approved by the Registrar on specified terms and conditions.

(v) In any other moneys permitted by the Central or State Government.

The principal provision relating to the investments of funds of a co-operative society, the Central as well as State Acts does not mention anything about the investment of reserve fund outside the business specifically.

Question 8

Write short notes on Powers and duties of an auditor of a Multi-state Cooperative Society.

Answer

Powers and duties of an auditor of a Multi-state Cooperative Society: Under Section 73 of the Multi-State Cooperative Societies Act, 2002 every auditor of a multi – State Co-operative Society shall have a right of access at all times to the books, accounts and vouchers of the Multi-State Co-operative Society whether kept at the head office of the Multi-State Co-operative Society or elsewhere and shall be entitled to require from the officers or other employees of the Multi-State Co-operative Society such information and explanation as the auditor may think necessary for the performance of the duties as an auditor.

As per section 73 (2) the auditor shall make the following inquiries:

(i) Whether loans and advances made by the Multi-State Co-operative Society 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 Multi-State Co-operative or its members;

(ii) Whether transactions of the Multi-State Co-operative Society which are represented merely by book entries are not prejudicial to the interest of the Multi-State Co-operative Society;

(iii) Whether personal expenses have been charged to revenue account; and

(iv) Where it is stated in the books and papers of the Multi-State Co-operative Society that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

13

Audit of Co-Operative Societies

Question 1

Write short notes on Aspects to be covered in the books of accounts to be maintained by a multi-state co-operative society. *(4 Marks, November, 2013)*

Or

State the requirements regarding the maintenance of books of accounts with respect to a multi-state co-operative society. *(4 Marks, May, 2011)*

Answer

Books of Accounts to be maintained by a Multi-state co-operative society: As per Multi-State co-operative society rules 2002, every Multi-State co-operative society shall keep books of account with respect to-

(i) all sum of money received and expended and matters in respect of which the receipt and expenditure take place;

(ii) all sale and purchase of goods;

(iii) the assets and liabilities;

(iv) in the case of a Multi-State co-operative society engaged in production, processing and manufacturing, particulars relating to utilization of materials or labour or other items of cost as may be specified in the bye-laws of such a society.

Comprehensively, the following books of accounts may be maintained:

(i) *Cash book:* It may be maintained to record particulars regarding cash receipts and expenses under suitable heads, with clear distinction between capital and revenue items of receipts and expenses.

(ii) *Stock registe*r: It may contain detailed information as regards receipts, issues and balances of stock-in-trade, date-wise. In a producers co-operative society, perpetual inventory records may be maintained based on an appropriate costing method.

(iii) *Register of assets and investments:* It will contain detailed particulars regarding the various immovable and movable assets belonging to the society, such as, types of assets, location, date of acquisition, cost, depreciation provided, and so on.

(iv) *Register of fixed deposits:* In the case of a co-operative credit society, or a co-operative bank, or any other society which is authorised by its laws to accept deposits from members/ non-members, a register of fixed deposits may be maintained giving details as regards the dates of acceptance, maturity, interest accrual, repayment, etc.

(v) *Register of sureties:* In the case of a co-operative credit society, loans are given against personal security of members as also surety (guarantee) provided by two other members. The Register of Sureties will give particulars about the number of borrowers in respect of which a member has stood surety, and show whether it is within the overall limit of surety-ship that may be given by a member as prescribed by the bye-laws.

(vi) *Register of loan disbursement and recovery:* In the ease of a co-operative credit society, this Register will provide particulars regarding loans sanctioned by the society, the dates of disbursement and recovery.

Question 2

Write short notes on Restrictions on investments of funds of a central co-operative society.

(4 Marks, May, 2013)

Answer

Restrictions on Investment of funds of a Central Cooperative Society: Provisions of the Central Act put some restrictions on investments of funds of a Central Cooperative Society. According to Section 32 of the Central Act, a Central Cooperative Society may invest its funds only in any one or more of the following-

(i) In the Central or State Co-operative Bank.

(ii) In any of the securities specified in Section 20 of the Indian Trusts Act, 1882.

(iii) In the shares, securities, bonds or debentures of any other society with limited liability.

(iv) In any co-operative bank, other than a Central or State co-operative bank, as approved by the Registrar on specified terms and conditions.

(v) In any other moneys permitted by the Central or State Government.

The principal provision relating to the investments of funds of a co-operative society, the Central as well as State Acts does not mention anything about the investment of reserve fund outside the business specifically.

Question 3

"Examination of overdue debts, audit classification of society, and reporting the infringement of provisions of the Act are the special features of audit of a co-operative society." Do you agree? *(6 Marks, November, 2010)*

Answer

Special Features of Co-operative Society Audit: The special features of co-operative society audit, to be borne in mind in general while conducting the audit are examination of overdue debts, overdue Interest, certification of bad debts, valuation of assets and liabilities, adherence to co-operative principles, reporting infringement of act and rules, verification of members' register and examination of their pass books, special report to the registrar, audit

classification of co-operative society, discussion of draft audit report with managing committee etc.

Besides the other special features mentioned above the Examination of overdue debts, audit classification of society and reporting the infringement of provisions of the Act, are some of special features of audit of a co-operative society which are explained as follows:

(i) **Examination of overdue debts**: Auditor of a co-operative society has to classify the overdue debts for a period from 6 months to five years and more than 5 years. Further these debts are to be analyzed in 'good' or 'bad' depending on the recoverability of the debts. The bad and doubtful debts require some provision and the auditor has to ascertain whether proper provision for bad & doubtful debts has been made. The current year's amount of overdue debts and its ratio to the working capital and loans outstanding is to be compared with last year to know whether the trend is increasing or decreasing. The status of the court cases for recovery of the overdue debts is also to be mentioned in the audit report. While calculating the profit the interest on the overdue debts is not to be taken into account. The Bad debts portion of the overdue debts is to be certified by the auditor for the purpose of writing off.

(ii) **Audit Classification of Co-operative Society**: It is a unique feature of the Co-operative audit. After completion of the audit the auditor has to evaluate the working of the society on the basis of various parameters and criteria which are specified by the Registrar. It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification. The auditor should be very careful, while making a decision about the class of society.–For good performance having certain marks "A class is given. The D class is given to the society which shows very poor performance. In the same way B or C class is awarded on the basis of the marks obtained by the society.

(iii) **Reporting infringement of Act and Rules**: The auditor of the co-operative Society is required to report the non compliance of the various provisions of the Co-operative Societies Act, Rules framed under that Act and the by laws of the society. He has to assess the financial implications of such infringements and disclose the same in his report. The infringements of serious nature are to be reported separately and infringements which do not have financial implications and which have no serious effect on the working of the society or rights of the members may be reported separately.

Thus we can say that Examination of overdue debts, audit classification of society and reporting the infringement of provisions of the Act, are only some of special features of audit of a co-operative society.

Question 4

Under what circumstances, an auditor is required to submit a special report to the registrar of Co-operative Societies? *(4 Marks, November, 2009)*

Or

Write short notes on Special Report by auditor to Registrar of Cooperative Societies.

(4 Marks, May, 2005)

Answer

Special Report by Auditor to Registrar of Co-operative Societies: Under the following circumstances, an auditor has to issue special report to the Registrar of Co-operative Societies (This report should be in addition to the regular report)-

(i) (a) Any member of the managing committee is involved in personal profit making by using the properties or assets of the society, resulting into the loss to the society.

(b) Frauds are detected from the society's transactions.

(ii) There is mismanagement in the society and the principles of co -operative are not maintained by the management.

(iii) In the respect of audit of Urban Co-operative Banks, disproportionate advances to vested interest groups. Such as relative 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.

Question 5

List the special features involved in the audit of a Cooperative Society. *(8 Marks, June, 2009)*

Or

State the special features of Co-operative Societies Audit. *(8 Marks, May, 2004)*

Answer

Special features of Co-operative Societies Audit: The special features of co-operative societies audit, to be borne in mind while conducting the audit are as follows-

(i) **Examination of overdue debts:** Overdue debts for a period from six months to five years and more than five years will have to be classified and shall have to be reported by an auditor. Overdue debts have far reaching consequences on the working of a credit society. It affects its working capital position. A further analysis of these overdue debts from the viewpoint of chances of recovery will have to be made, and they will have to be classified as good or bad. The auditor will have to ascertain whether proper provisions for doubtful debts is made and whether the same is satisfactory. The percentage of overdue debts to the working, capital and loans advanced will have to be compared with last year, so as to see whether the trend is increasing or decreasing whether due and proper actions for recovery are taken, the position regarding cases in co-operative courts, District Courts etc. and the results thereof.

(ii) **Overdue Interest:** Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue.

(iii) **Certification of Bad Debts:** A peculiar feature regarding the writing off of the bad debts as per Maharashtra State Co-operative Rules, 1961, is very interesting to note. As per Rule No. 49, bad debts can be written off only when they are certified as bad by the auditor. Bad debts and irrecoverable losses before being written off against Bad Debts Funds, Reserve Fund etc. should be certified as bad debts or irrecoverable losses by the auditor where the law so requires. Where no such requirement exists, the managing committee of the society must authorise the write-off.

(iv) **Valuation of Assets and Liabilities:** Regarding valuation of assets there are no specific provisions or instructions under the Act and Rules and as such due regard shall be had to the general principles of accounting and auditing conventions and standards adopted. The auditor will have to ascertain existence, ownership and valuation of assets. Fixed assets should be valued at cost less adequate provision for depreciation. The incidental expenses incurred in the acquisition and the installation expenses of assets should be properly capitalised. If the difference in the original cost of acquisition and the present market price is of far reaching significance, a note regarding the present market value may be appended; so as to have a proper disclosure in the light of present inflatory conditions. The current assets be valued at cost or market price, whichever is lower. Regarding the liabilities, the auditor should see that all the known liabilities are brought into the account, and the contingent liabilities are stated by way of a note.

(v) **Adherence to Co-operative Principles:** The auditor will have to ascertain in general, how far the objects, for which the co-operative organisation is set up, have been achieved in the course of its working. While auditing the expenses, the auditor should see that they are economically incurred and there is no wastage of funds. Middlemen commissions are, as far as possible, avoided and the purchases are made by the committee members directly from the wholesalers. The principles of propriety audit should be followed for the purpose.

(vi) **Observations of the Provisions of the Act and Rules:** An auditor of a co-operative society is required to point out the infringement with the provisions of Co-operative Societies Act and Rules and bye-laws. The financial implications of such infringements should be properly assessed by the auditor and they should be reported. Some of the State Acts contain restrictions on payment of dividends, which should be noted by the auditor.

(vii) **Verification of Members' Register and examination of their pass books:** Examination of entries in members, pass books regarding the loan given and its repayments, and confirmation of loan balances in person is very much important in a co-operative organisation to assure that the entries in the books of accounts are free from manipulation.

(viii) **Special report to the Registrar:** 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 such irregularities. 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-

(a) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.

(b) Detection of fraud relating to expenses, purchases, property and stores of the society.

(c) Specific examples of mis-management including decisions of management against co-operative principles.

(d) 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.

(ix) **Audit classification of society:** After a judgement of an overall performance of the society, the auditor has to award a class to the society. This judgement is to be based on the criteria specified by the Registrar. It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification. The auditor should be very careful, while making a decision about the class of society.

(x) **Discussion of draft audit report with managing committee -** On conclusion of the audit, the auditor should ask the Secretary of the society to convene the managing committee meeting to discuss the audit draft report. The audit report should never be finalised without discussion with the managing committee. Minor irregularities may be got settled and rectified. Matters of policy should be discussed in detail.

Question 6

Write short notes on Powers and duties of an auditor of a Multi-state Cooperative Society.

(4 Marks, November, 2006)

Answer

Powers and duties of an auditor of a Multi-state Cooperative Society: Under Section 73 of the Multi-State Cooperative Societies Act, 2002 every auditor of a multi – State Co-operative Society shall have a right of access at all times to the books, accounts and vouchers of the Multi-State Co-operative Society whether kept at the head office of the Multi-State Co-operative Society or elsewhere and shall be entitled to require from the officers or other employees of the Multi-State Co-operative Society such information and explanation as the auditor may think necessary for the performance of the duties as an auditor.

As per section 73 (2) the auditor shall make the following inquiries:

(i) Whether loans and advances made by the Multi-State Co-operative Society 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 Multi-State Co-operative or its members;

(ii) Whether transactions of the Multi-State Co-operative Society which are represented merely by book entries are not prejudicial to the interest of the Multi-State Co-operative Society;

(iii) Whether personal expenses have been charged to revenue account; and

(iv) Where it is stated in the books and papers of the Multi-State Co-operative Society that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

14

Audit of Non Banking Financial Companies

Question 1

What is a Non-Banking Financial Company (NBFC)?

Answer

Definition of Non-Banking Financial Company (NBFC): Section 45 I(f) of Reserve Bank of India (Amendment) Act, 1997 defines a non-banking financial company as:

(i) A financial institution which is a company;

(ii) A non banking institution which is a company with principal business of receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

(iii) Such other non-banking institution or class of such institutions, as the Reserve Bank with the previous approval of the Central Government may specify by notification in the Official Gazette.

For purposes of RBI Directions relating to Acceptance of Public Deposits, non-banking financial company means only the non-banking institution which is a –¨Loan company, Investment company, Hire purchase finance company, Equipment leasing company and Mutual benefit financial company".

Question 2

What are the different types of NBFCs registered with RBI?

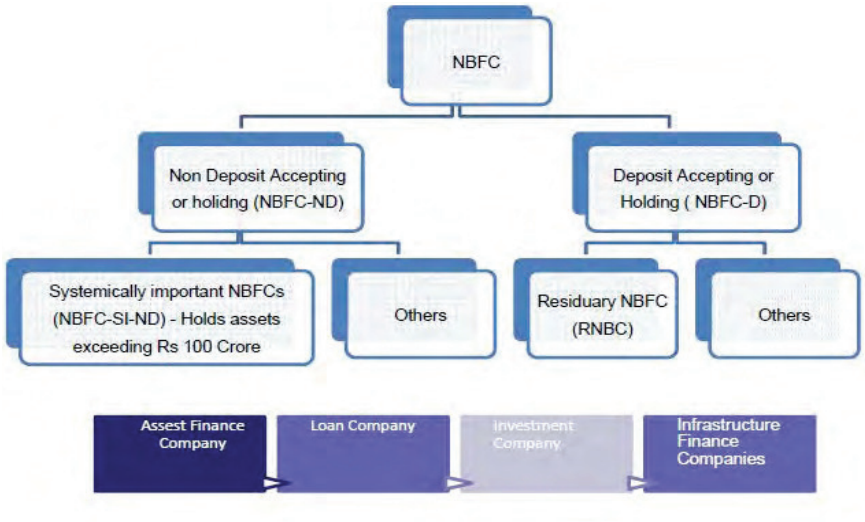
Answer

Categories of Non-Banking Financial Company: In terms of the Section 45-I(f) read with Section 45-I (c)of the RBI Act, 1934, as amended in 1997, NBFC is one whose principal business is that of receiving deposits or that of a financial institution, such as lending, investment in securities, hire purchase finance or equipment leasing. Consequent upon to RBI Circular December 6, 2006, companies financing real/physical assets for productive/ economic activity will be classified as Asset Finance Company (AFC) as per the specified criteria. The remaining companies would be continued to be classified as loan/investment companies. In the proposed structure the following categories of NBFCs will emerge:

Currently, NBFCs registered with RBI are being classified as:

- **Asset Finance Company (AFC) -** The main activity of an AFC is financing of physical assets supporting productive / economic activity. These may be in the areas such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments and general purpose industrial machines.
- **Investment Company (IC)** which mainly deal in acquisition of shares and securities of other companies. A core investment company would be a company which acquires shares and securities of Group companies.
- **Loan Company (LC) -** Loan companies primarily provide finance (whether by making loans or advances or otherwise for any activity), other than its own activity.
- **Infrastructure Finance Companies -** This category of NBFCs deploys a minimum of three-fourths of their total assets in infrastructure loans. The net owned funds of this category of NBFCs are more than ₹ 300 crores and they should have a minimum credit rating of 'A' or equivalent and the Capital to Risk-Weighted Assets Ratio (CRAR) is 15% (with a minimum Tier I Capital of 10%).
- **Core Investment Company (CIC) -** These are NBFCs which carry on the business of acquisition of shares and securities in group companies and satisfies four conditions stated in the regulatory framework for Core Investment Companies issued by RBI.
- **Infrastructure Debt Fund- Non-Banking Financial Company (IDF-NBFC) -** Infrastructure Debt Funds (IDFs) are funds set up to facilitate the flow of long-term debt into infrastructure projects. The IDF will be set up either as a trust or as a company. A trust based IDF would normally be a Mutual Fund (MF) while a company based IDF would normally be a NBFC.
- **Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI) -** An NBFC-MFI is defined as a non-deposit taking NBFC (other than a company licensed under Section 25 of the Indian Companies Act, 1956 ***{now section 8 of the Companies Act, 2013}***) that fulfils certain conditions.

The above type of companies may be further classified into those accepting deposits or those not accepting deposits.



Core Investment Companies, Infrastructure Debt Fund NBFC and NBFC – Micro Finance Institution (other than Companies Act, 1956 - Section 25 companies ***{now section 8 of the Companies Act, 2013}***) are non deposit holding Companies.

Others

Housing Finance Companies: National Housing Board set up by the Government of India is the Apex authority regulating the housing finance companies. The Housing Finance Companies (NHB) Directions, 2010 deals with matters relating to acceptance of deposits by housing finance companies, prudential norms for income recognition, accounting standards, asset classification, provision for bad and doubtful assets, capital adequacy and concentration of credit/ investments to be observed by the housing finance companies and matters to be included in the auditors report by the auditors of such housing finance companies and matters ancillary and incidental thereto and amended the said directions from time to time.

Question 3

You are the auditor of IJK Ltd., a NBFC registered with RBI. How would you proceed to ensure the compliance of Prudential Norms directions by it.

Answer

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 Statement of Profit and Loss.

(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.

Question 4

Enumerate the verification procedures in relation to audit of a Hire-Purchase Finance Company.

Answer

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.

Question 5

Write short notes on the special points that may be covered in the audit of equipment leasing finance company.

Answer

Special Points in the Audit of equipment leasing finance company: The auditor should-

(i) Ascertain whether the Non Banking Financial Companies (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.

Question 6

List the matters to be included in the 'Auditor's report' in the case of Non Banking Financial Companies (NBFCs).

Answer

The auditor's report on the accounts of a non-banking financial company shall include a statement on the following matters, namely:

(A) In the case of all non-banking financial companies-

(i) Whether the company is engaged in the business of non-banking financial institution and whether it has obtained a Certificate of Registration (CoR) from the Bank.

(ii) In the case of a company holding CoR issued by the Bank, whether that company is entitled to continue to hold such CoR in terms of its asset/income pattern as on March 31 of the applicable year.

(B) In the case of a non-banking financial company accepting/holding public deposits-

Apart from the matters enumerated in (A) above, the auditor shall include a statement on the following matters, namely:-

(i) Whether the public deposits accepted by the company together with other borrowings indicated below viz;

(a) from public by issue of unsecured non-convertible debentures/bonds;

(b) from its shareholders (if it is a public limited company) and

(c) which are not excluded from the definition of 'public deposit' in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 are within the limits admissible to the company as per the provisions of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998;

(ii) Whether the public deposits held by the company in excess of the quantum of such deposits permissible to it under the provisions of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 are regularised in the manner provided in the said Directions;

(iii) Whether an Asset Finance Company having Capital to Risk Assets Ratio (CRAR) less than 15% or an Investment Company or a Loan Company as defined in paragraph 2(1)(ia), (vi) and (viii) respectively of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 is accepting "public deposit" without minimum investment grade credit rating from an approved credit rating agency;

(iv) In respect of NBFCs referred to in clause (iii) above, whether the credit rating, for each of the fixed deposits schemes that has been assigned by one of the Credit Rating Agencies listed in Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998

(a) is in force; and

(b) whether the aggregate amount of deposits outstanding as at any point during the year has exceeded the limit specified by the such Credit Rating Agency;

(v) In case of NBFCs having Net Owned Funds of ` 25 lakh and above but less than ` 200 lakhs, whether the public deposit held by the companies is in excess of the quantum of such deposit permissible to it in terms of Notification No. DNBS. 199/CGM (PK) - 2008 dated June 17, 2008 and whether such company :

(a) has frozen its level of deposits as on the date of that Notification; or

(b) has brought down its level of deposits to the level of revised ceiling of deposits in terms of that Notification.

(vi) Whether the company has defaulted in paying to its depositors the interest and /or principal amount of the deposits after such interest and/or principal became due;

(vii) Whether the company has complied with the prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, and concentration of credit/investments as specified in

the Directions issued by the Reserve Bank of India in terms of the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;

(viii) Whether the capital adequacy ratio as disclosed in the return submitted to the Bank in terms of the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 has been correctly determined and whether such ratio is in compliance with the minimum CRAR prescribed therein;

(ix) Whether the company has complied with the liquid assets requirement as prescribed by the Bank in exercise of powers under section 45-IB of the RBI Act and whether the details of the designated bank in which the approved securities are held is communicated to the office concerned of the Bank in terms of Notification no. - DNBS.172/CGM(OPA)-2003 dated July 31, 2003;

(x) Whether the company has furnished to the Bank within the stipulated period the return on deposits as specified in the NBS 1 to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998;

(xi) Whether the company has furnished to the Bank within the stipulated period the half-yearly return on prudential norms as specified in the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;

(xii) Whether, in the case of opening of new branches or offices to collect deposits or in the case of closure of existing branches/offices or in the case of appointment of agent, the company has complied with the requirements contained in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.

(C) In the case of a non-banking financial company not accepting public deposits-

Apart from the aspects enumerated in (A) above, the auditor shall include a statement on the following matters, namely:-

(i) Whether the Board of Directors has passed a resolution for non- acceptance of any public deposits.

(ii) Whether the company has accepted any public deposits during the relevant period/year.

(iii) Whether the company has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to it in terms of Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.

(iv) In respect of Systemically Important Non-deposit taking NBFCs as defined in paragraph 2(1)(xix) of the Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 -

(a) whether the capital adequacy ratio as disclosed in the return submitted to the Bank in form NBS- 7, has been correctly arrived at and whether such ratio is in compliance with the minimum CRAR prescribed by the Bank;

(b) whether the company has furnished to the Bank the annual statement of capital funds, risk assets/exposures and risk asset ratio (NBS-7) within the stipulated period.

(D) In the case of a company engaged in the business of non-banking financial institution not required to hold CoR subject to certain conditions-

Apart from the matters enumerated in (A)(I) above, the auditor shall include a statement on the following matters, namely:

Where a Company has obtained a specific advice from the Bank that it is not required to hold CoR from the Bank whether the company is complying with the conditions stipulated as advised by the Bank.

Question 7

Write short notes on - Classification of frauds by NBFC.

Answer

Classification of Frauds by NBFC: In order to have uniformity in reporting, frauds have been classified as under:

(i) Misappropriation and criminal breach of trust.

(ii) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.

(iii) Unauthorised credit facilities extended for reward or for illegal gratification.

(iv) Negligence and cash shortages.

(v) Cheating and forgery.

(vi) Irregularities in foreign exchange transactions.

(vii) Any other type of fraud not coming under the specific heads as above.

Cases of 'negligence and cash shortages' and 'irregularities in foreign exchange transactions' referred to in items (iv) and (v) above are to be reported as fraud if the intention to cheat/ defraud is suspected/ proved. However, the following cases where fraudulent intention is not suspected/ proved, at the time of detection, will be treated as fraud and reported accordingly:

(i) cases of cash shortages more than ₹ 10,000/- and

(ii) cases of cash shortages more than ₹ 5000/- if detected by management/ auditor/ inspecting officer and not reported on the occurrence by the persons handling cash.

NBFCs having overseas branches/offices should report all frauds perpetrated at such branches/offices also to the Reserve Bank as per the prescribed format and procedures.

14

Audit of Non-Banking Financial Companies

Question 1

As an auditor of a Non Banking Financial Company registered with the Reserve Bank of India (RBI), what are the prudential norms of RBI, whose compliance is to be verified?

(6 Marks, November, 2012)

Or

You are the auditor of IJK Ltd., a NBFC registered with RBI. How would you proceed to ensure the compliance of Prudential Norms directions by it. (4 Marks, November, 2008)

Answer

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.

Question 2

Write short notes on Special points that may be covered in the audit of equipment leasing finance company. (4 Marks, May, 2010)

Or

What are the special points in the audit of a Non-Banking Equipment Leasing Finance Company? (8 Marks, May, 2007)

Answer

Special Points in the Audit of Non Banking Equipment Leasing Finance (NBELF) Company: The auditor should

(i) Ascertain whether the Non Banking Financial Companies (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.

Question 3

Enumerate the verification procedures in relation to audit of a Hire-Purchase Finance Company.

(8 Marks, June, 2009)

Answer

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.

Question 4

List the matters to be included in the 'Auditors' report' in the case of Non Banking Financial Companies (NBFCs) accepting or holding public deposits. (8 Marks, November, 2007)

Answer

The auditor's report on the accounts of a non-banking financial company shall include a statement on the following matters, namely:

(A) In the case of all non-banking financial companies

(i) Whether the company is engaged in the business of non-banking financial institution and whether it has obtained a Certificate of Registration (CoR) from the Bank.

(ii) In the case of a company holding CoR issued by the Bank, whether that company is entitled to continue to hold such CoR in terms of its asset/income pattern as on March 31 of the applicable year.

(B) In the case of a non-banking financial company accepting/holding public deposits

Apart from the matters enumerated in (A) above, the auditor shall include a statement on the following matters, namely:-

(i) Whether the public deposits accepted by the company together with other borrowings indicated below viz;

(a) from public by issue of unsecured non-convertible debentures/bonds;

(b) from its shareholders (if it is a public limited company) and

(c) which are not excluded from the definition of 'public deposit' in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 are within the limits admissible to the company as per the provisions of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998;

(ii) Whether the public deposits held by the company in excess of the quantum of such deposits permissible to it under the provisions of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 are regularised in the manner provided in the said Directions;

(iii) Whether an Asset Finance Company having Capital to Risk Assets Ratio (CRAR) less than 15% or an Investment Company or a Loan Company as defined in paragraph 2(1)(ia), (vi) and (viii) respectively of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 is accepting "public deposit" without minimum investment grade credit rating from an approved credit rating agency;

(iv) In respect of NBFCs referred to in clause (iii) above, whether the credit rating, for each of the fixed deposits schemes that has been assigned by one of the Credit Rating Agencies listed in Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998

(a) is in force; and

(b) whether the aggregate amount of deposits outstanding as at any point during the year has exceeded the limit specified by the such Credit Rating Agency;

(v) In case of NBFCs having Net Owned Funds of ₹ 25 lakh and above but less than ₹ 200 lakhs, whether the public deposit held by the companies is in excess of the quantum of such deposit permissible to it in terms of Notification No. DNBS. 199/CGM (PK) - 2008 dated June 17, 2008 and whether such company :

(a) has frozen its level of deposits as on the date of that Notification; or

(b) has brought down its level of deposits to the level of revised ceiling of deposits in terms of that Notification.

(vi) Whether the company has defaulted in paying to its depositors the interest and /or principal amount of the deposits after such interest and/or principal became due;

(vii) Whether the company has complied with the prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, and concentration of credit/investments as specified in the Directions issued by the Reserve Bank of India in terms of the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.

(viii) Whether the capital adequacy ratio as disclosed in the return submitted to the Bank in terms of the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 has been correctly determined

and whether such ratio is in compliance with the minimum CRAR prescribed therein;

(ix) Whether the company has complied with the liquid assets requirement as prescribed by the Bank in exercise of powers under section 45-IB of the RBI Act and whether the details of the designated bank in which the approved securities are held is communicated to the office concerned of the Bank in terms of NOTIFICATION NO.DNBS.172/CGM(OPA)-2003 dated July 31, 2003;

(x) Whether the company has furnished to the Bank within the stipulated period the return on deposits as specified in the NBS 1 to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998;

(xi) Whether the company has furnished to the Bank within the stipulated period the half-yearly return on prudential norms as specified in the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;

(xii) Whether, in the case of opening of new branches or offices to collect deposits or in the case of closure of existing branches/offices or in the case of appointment of agent, the company has complied with the requirements contained in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.

(C) In the case of a non-banking financial company not accepting public deposits

Apart from the aspects enumerated in (A) above, the auditor shall include a statement on the following matters, namely: -

(i) Whether the Board of Directors has passed a resolution for non- acceptance of any public deposits.

(ii) Whether the company has accepted any public deposits during the relevant period/year;

(iii) Whether the company has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to it in terms of Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.

(iv) In respect of Systemically Important Non-deposit taking NBFCs as defined in paragraph 2(1)(xix) of the Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 -

(a) whether the capital adequacy ratio as disclosed in the return submitted to the Bank in form NBS- 7, has been correctly arrived at and whether such ratio is in compliance with the minimum CRAR prescribed by the Bank;

(b) whether the company has furnished to the Bank the annual statement of capital funds, risk assets/exposures and risk asset ratio (NBS-7) within the stipulated period.

(D) In the case of a company engaged in the business of non-banking financial institution not required to hold CoR subject to certain conditions : Apart from the matters enumerated in (A)(I) above, the auditor shall include a statement on the following matters, namely:

Where a Company has obtained a specific advice from the Bank that it is not required to hold CoR from the Bank whether the company is complying with the conditions stipulated as advised by the Bank.

Question 5

Write short notes on Categories of Non-banking Finance Companies (NBFCs).

(4 Marks, November, 2005)

Answer

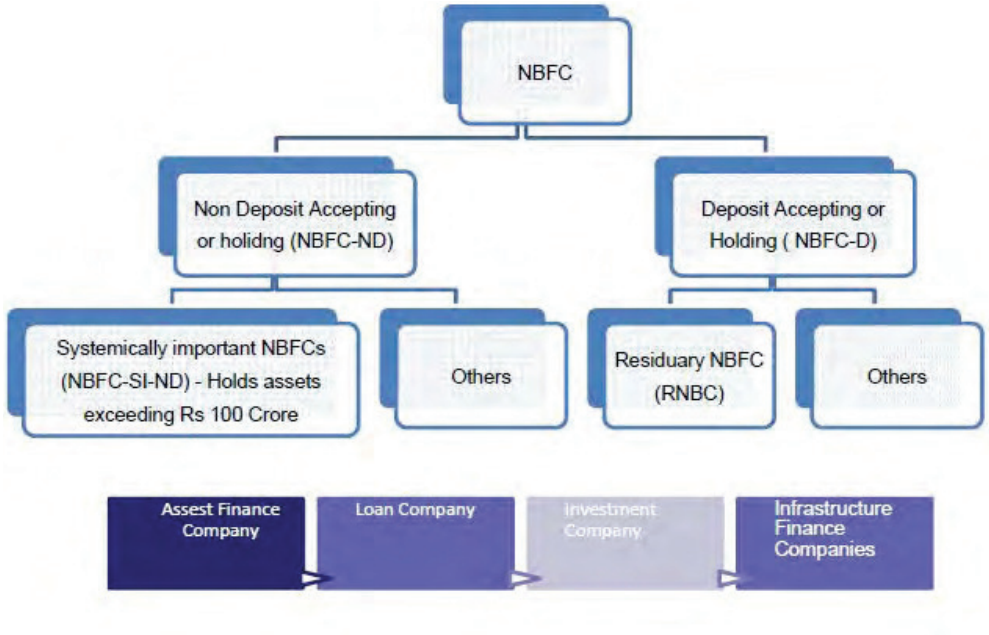
Categories of Non-Banking Financial Company - In terms of the Section 45-I(f) read with Section 45-I (c)of the RBI Act, 1934, as amended in 1997, NBFC is one whose principal business is that of receiving deposits or that of a financial institution, such as lending, investment in securities, hire purchase finance or equipment leasing. Consequent upon to RBI Circular December 6, 2006, companies financing real/physical assets for productive/ economic activity will be classified as Asset Finance Company (AFC) as per the specified criteria. The remaining companies would be continued to be classified as loan/investment companies. In the proposed structure the following categories of NBFCs will emerge:

Currently, NBFCs registered with RBI are being classified as:

- Asset Finance Company (AFC) - The main activity of an AFC is financing of physical assets supporting productive / economic activity. These may be in the areas such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments and general purpose industrial machines.
- Investment Company (IC) which mainly deal in acquisition of shares and securities of other companies. A core investment company would be a company which acquires shares and securities of Group companies.
- Loan Company (LC): Loan companies primarily provide finance (whether by making loans or advances or otherwise for any activity), other than its own activity.
- Infrastructure Finance Companies: This category of NBFCs deploys a minimum of three-fourths of their total assets in infrastructure loans. The net owned funds of this category of NBFCs are more than ₹ 300 crores and they should have a minimum credit rating of 'A' or equivalent and the Capital to Risk-Weighted Assets Ratio (CRAR) is 15% (with a minimum Tier I Capital of 10%).

- Core Investment Company (CIC): These are NBFCs which carry on the business of acquisition of shares and securities in group companies and satisfies four conditions stated in the regulatory framework for Core Investment Companies issued by RBI.
- Infrastructure Debt Fund- Non- Banking Financial Company (IDF-NBFC) - Infrastructure Debt Funds (IDFs) are funds set up to facilitate the flow of long-term debt into infrastructure projects. The IDF will be set up either as a trust or as a company. A trust based IDF would normally be a Mutual Fund (MF) while a company based IDF would normally be a NBFC.
- Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI) - An NBFC-MFI is defined as a non-deposit taking NBFC (other than a company licensed under Section 25 of the Indian Companies Act, 1956{now section 8 of the Companies Act, 2013}) that fulfils certain conditions.

  The above type of companies may be further classified into those accepting deposits or those not accepting deposits.



Core Investment Companies, Infrastructure Debt Fund NBFC and NBFC – Micro Finance Institution (other than Companies Act, 1956 - Section 25 companies{now section 8 of the Companies Act, 2013}) are non deposit holding Companies.

Others

Housing Finance Companies : National Housing Board set up by the Government of India is the Apex authority regulating the housing finance companies. The Housing Finance Companies (NHB) Directions, 2010 deals with matters relating to acceptance of deposits by housing finance companies, prudential norms for income recognition, accounting standards, asset classification, provision for bad and doubtful assets, capital adequacy and concentration of credit/ investments to be observed by the housing finance companies and matters to be included in the auditors report by the auditors of such housing finance companies and matters ancillary and incidental thereto and amended the said directions from time to time.

15

Audit under Fiscal Laws

Question 1

State with reasons whether an auditor conducting tax audit 'certifies' or 'reports' on information contained in the statement of particulars attached to the tax audit report under Section 44AB of Income-tax Act, 1961.

Answer

Section 44AB of the Income-tax Act, 1961 requires the auditor to submit the audit report in the prescribed form and setting forth prescribed particulars. The statement of particulars as required in Form 3CD are required to be annexed to the main audit report. The audit report is in two parts. The first part requires the auditor to give his opinion as to whether or not the accounts audited by him give a true and fair view and the second part of the report is in the form of an "Annexure" containing statement of particulars in respect of certain specified matters. The tax auditor has to report whether particulars are true and correct.

In this context, it is important to appreciate the distinction between the terms "report" and "certificate". Briefly speaking, the term "certificate" is used where the auditor verifies the accuracy of facts while the term "report" is used in case the auditor is expressing an opinion. Strictly speaking, having regard to the usage of the word true and correct, these particulars require definitive information compiled from the books of account. Hence, it can be said that an auditor conducting tax audit 'certifies" the information contained in the statement of particulars. However, having regard to the distinction, it is significant to examine whether all thirty two clauses included in the statement of particulars are capable of being simply certified on the basis of books of account or there are some clauses in respect of which different auditor(s) may hold different opinion. For instance, ***Clause 14*** dealing with valuation of closing stock would require the auditor to examine and opine on the basis adopted for ascertaining the cost and, thus, to ensure that method followed for valuation of stock results in disclosure of correct profits and gains. Similarly, ***Clause 18*** relating to depreciation would require the auditor to exercise judgement having regard to the facts and circumstances of the case, etc. Thus, there are several matters on which the auditor is required to exercise judgement while giving his report on various amounts included in the statement of particulars. No doubt that the auditor obtains the statement of particulars in Form No. 3CD duly authenticated by the assessee, it does not merely involve checking the corresponding figures with the documents and books of account but requires the auditor to exercise his judgement which may at times lead to different figures by different persons reporting thereon. There can also be situations leading to difference of opinion between the tax auditor and the assessee. Therefore, it can be said that an auditor conducting tax audit "reports" on certain information, apart from certifying certain factual information contained in the statement of particulars annexed to the tax audit report under section 44AB of the Income-tax Act, 1961.

Question 2

A leading jewellery merchant used to value his inventory at cost on LIFO basis. However, for the current year, in view of requirements of AS 2, he changed over to FIFO method of valuation. The difference in value of stock amounted to ₹ 55 lakhs which is higher than that under the previous method. In such a situation, what are the reporting responsibilities of a Tax Auditor under Section 44AB of Income-tax Act, 1961.

Answer

Reporting for change in the method of valuation of stock: The change in the method of valuation of stock is not a change in method of accounting, as it is only a change in accounting policy. However in the Income-tax Act, 1961 this is considered under method of accounting. Under the Income-tax Act, 1961, if the change in method of valuation is bonafide, and is regularly and consistently adopted in the subsequent years as well, such change would be permitted to be made for tax purposes. In the instant case, the change in the valuation of stock from LIFO basis to FIFO basis is pursuant to mandatory requirements of the AS 2 'Valuation of Inventories' and therefore should be viewed as bonafide change.

This apart, the tax auditor in his report has to specifically refer to the method of valuation of stock under ***Clause 14*** in Form 3CD.

(a) Method of valuation of closing stock employed in the previous year.

(b) Details of deviation, if any, from the method of valuation prescribed under section 145A and the effect thereof on profit or loss.

The auditor has to see that the method of stock valuation is followed consistently from year to year. It is also necessary to ensure that method followed for valuation of stock results is correct profits or gain. The change from LIFO to FIFO is bonafide, the disclosure of which would have to be made the financial statements. As far as section 145A is concerned, the tax auditor need not change the method of valuation of purchases, sales and inventories which is regularly employed by the assessee. All that he has to do is to adjust the valuation for any tax, duty, cess or fee actually paid or incurred by the assessee, if the same had not already been adjusted.

Question 3

As a tax auditor, which are the accounting ratios required to be mentioned in the report in case of manufacturing entities? Explain in detail any one of the above ratios and how does it help the tax auditor in his analytical review.

Answer

Accounting Ratios in Form 3CD of Tax Audit: A tax auditor is required to provide details regarding turnover, gross profit, etc., for the previous year as well as for the preceding previous year in Form 3CD. The ratios which are to be calculated for manufacturing entities are:

- Gross profit / Turnover
- Net Profit / Turnover
- Stock-in-trade/Turnover
- Material consumed / Finished goods provided

Ratio analysis constitutes a substantive auditing procedure designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. Such assessment is necessary in organisation having large volumes of transactions and in the organisation following mechanised accounting system where it is not possible to check each and every transaction. It has the merit of bringing to focus the abnormal deviations and unexpected variations which the normal routine checking in auditing may fall to reveal. Ratios highlight only symptoms and that too as of a particular day and the auditor should study these symptoms properly, correlate them and reach definite conclusions or identify areas for further enquiries. The auditor should by relating sales with the net profit, various items of direct and indirect costs and gross profit gather information about the profitability and operating efficiency of an enterprise; variations in any of these ratios in a particular year should be inquired by the auditor. The fall in the gross profit ratio and profitability ratio should alert the auditor who should ask the management for the reasons thereof and which should be carefully examined by him. The auditor should by relating sales with the net profit, various items of direct and indirect costs and gross profit gather information about the profitability and operating efficiency of an enterprise; variations in any of these ratios in a particular year should be inquired by the auditor. The fall in the gross profit ratio and profitability ratio should alert the auditor who should ask the management for the reasons thereof and which should be carefully examined by him.

These ratios have to be given for the business as a whole and not product wise. While calculating these ratios, the tax auditor should assign a meaning to the terms used in the above ratios having due regard to the generally accepted accounting principles. All the ratios mentioned in the clause are to be calculated in terms of value only.

The relationship of stock-in-trade to turnover over a period of time would reveal whether the entity has been accumulating stocks or there is a decline in the same. The auditor may obtain data for about 7-10 years, compute ratio of stock-in-trade/turnover and plot it on a graph paper over a period of time. This may give rise to several possibilities such as parallel horizontal lines, vertical rising line or a vertical falling line. A study of this relationship would reveal whether stocks are being accumulated or they are dwindling over a period. Such information would provide an input to tax auditor as to whether figures of either stock or turnover are being manipulated. Sometimes, while studying the relationship, it may show sudden decline or increase at a point of time which reflect that there is definitely something wrong with the figures of stock. Therefore, a close examination of such ratios helps the tax auditor to focus on major deviations and consequently reasons for the same.

Question 4

Write short notes on the following:

(a) Recognition of Deferred Tax Assets

(b) Deferred Taxation

Answer

(a) Recognition of Deferred Tax Assets: Deferred Tax Assets (DTA) are to be recognised as laid down by AS 22 "Accounting for Taxes on Income". A DTA arises on account of a timing difference in which the taxable income is more than the book income. A deferred tax asset (and the corresponding tax saving) should be recognised only after applying the test of prudence. Thus, where the enterprise does not have unabsorbed depreciation and carried forward losses as per the tax laws, deferred tax assets should be recognised and carried forward to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realized. In other words, no deferred tax asset should be created if there is no reasonable certainty about the requisite future taxable income. The existence or absence of a reasonable level of certainty would normally be determined by examining the past record of the reasonable and by making realistic estimates of profits for the future.

A much stricter test of prudence has to be satisfied where the enterprise has unabsorbed depreciation or carried forward losses under tax laws. In such a situation, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realized. The existence of unabsorbed depreciation or carried forward losses under tax laws is strong evidence that future taxable income may not be available. Therefore, in such a situation, the enterprise can recognise deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient taxable income or there is other convincing evidence of virtual certainty of availability of sufficient taxable income against which deferred tax assets can be realized.

ICAI has stated that virtual certainty refers to the extent of certainty which, for all practical purposes, can be considered certain. Determination of virtual certainty of availability of sufficient future taxable income is a matter of judgement which will have to be made on a case-to-case basis.

(b) Deferred Taxation: AS 22, Accounting for Taxes on Income, prescribes the accounting treatment for taxes on income. The amount of taxable income for a period and the amount of profit (or loss) as shown by the profit and loss account for that period are seldom the same. The difference between accounting income and taxable income arise due to the fact that taxable income is calculated in accordance with tax laws whose requirements regarding computation of taxable income differ from the accounting policies applied to determine accounting income. The difference between taxable income and accounting income can be classified into 'permanent differences' and 'timing differences'. 'Permanent differences' are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently. Timing differences, on the other hand, are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. The standard requires that deferred tax should be recognized for all timing differences, subject to the consideration of prudence in respect

of deferred tax assets. Deferred tax represents the future tax effects of timing differences. Some timing differences are such that their reversal in future year(s) would result in the taxable income for the year(s) of reversal being higher than the accounting income for that year (or those years).

Question 5

As a tax auditor, how would you report on the labour charges paid on which tax is deducted at source at an inappropriate rate.?

Answer

Reporting in Form 3CD: Section 40(a)(ia) of the Income-tax Act, 1961 specifies that amounts payable to a contractor or sub-contractor, being resident, for carrying out any work (including supply of labour for carrying out any work) on which tax is deductible under Chapter XVII-B and such tax has not been deducted or after deduction has not been paid on or before the due date specified in sub-section (1) of section 139, shall not be deducted in computing the income. Therefore, if tax is deducted at an inappropriate rate, the amount is disallowable under section 40(a)(ia) of the Income-tax Act. This fact needs to be reported in Clause 21(b)(ii) of Form 3CD where details of payment on which tax not deducted and details of payment on which tax has been deducted but not paid on or before the due date specified in sub- section (1) of section 139 needs to be reported. In case, the assessee submits that the rate is proper, though in the auditor's view it is improper, the tax auditor should exercise his judgement and accordingly report in Clause 21(b)(ii) of Form 3CD.

Question 6

Write a short note on - Method of accounting in Form No. 3CD of Tax Audit.

Answer

Method of accounting in Form No. 3CD of Tax Audit: Clause 13 of Form No. 3CD of the tax audit requires to state method of accounting employed in the previous year. It also requires to state the change in method of accounting vis-à-vis the preceding year. If so, details of change and the effect on the profit or loss are to be stated. Also details of deviation thereof if any, from accounting standards prescribed under section 145 and the effect thereof on the profit or loss are stated.

Section 145 provide that method of accounting be either cash or mercantile. Hybrid system is not permitted.

Question 7

What are the steps for the Audit under the State level 'Value Added Tax' (VAT)?

Answer

Steps required for Tax audit under VAT: VAT is a tax on the value added to the commodity at each stage in the production and distribution chain. VAT is an indirect Tax on consumption. It is a tax on the value at the retail point of sale which is collected at each stage of sale. The essence of VAT is that it provides credit set off for input tax i.e. tax paid on purchases against the output tax i.e. tax payable on sales. A tax auditor has to make certain preliminary preparations before the actual execution of tax audit under the VAT law. The major steps required to be undertaken for the preparation are as under-

(i) **Knowledge of business:** After accepting the audit assignment the auditor should familiarize himself with the business of the auditee. In this regard, the auditor should refer to the SA 315 - "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment" issued by the Council of the Institute of Chartered Accountants of India. Before starting the audit, the auditor should have a preliminary knowledge of the industry/ business and of the nature of ownership, management etc. More detailed information should be obtained and should be assessed and updated during the course of audit. For this purpose the various sources of information may be tapped. The knowledge of business is important not only to the auditor but also to his staff engaged in the audit. The auditor has to ensure that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to carry out the audit work delegated to them and further they should make effective use of the knowledge about the business and should consider how it affects the tax liability reported in the return. The facts and figures in the returns should be consistent with the auditor's knowledge of the business. The auditor should also make himself familiar with the process of production and the distribution chain. The auditor should also obtain information about whether the auditee is a manufacturer/ importer/ retailer, the details of major customers to whom the sales are effected and the details of sales which are outside the scope of VAT law. Similarly the sources of purchase and the items sold should be listed out. Further it should be ascertained whether the auditee has opted for the composition scheme or not.

(ii) **Obtaining a list of all the accounting records maintained by the auditee:** The auditor should obtain a complete list of all the accounting records relating to sale/purchase of goods, stocks, the various registers, the ledgers etc. maintained, in which the transactions are recorded, the various source documents in which the entries are recorded in the books of account and the process of their generation. VAT is a state subject and therefore each state has a separate legislation governing VAT, wherein the prescribed format are provided in respect to various accounting records prescribed to be maintained by VAT legislation.

(iii) **Ascertaining the major accounting policies adopted by the auditee:** The auditor should know the major accounting polices based on which books of account have been recorded. The accounting policy regarding recording of sales, purchases and valuation of inventory must be made known and the auditor should also find out whether there has been any change in those policies during the year covered by audit. If there is any significant change in the accounting policy giving rise to some material effect on the tax liability, the same should be invariably reported. While conducting an audit under VAT, special care is required to be taken in respect to accounting policy and treatment of stock transfer to branches. According

to VAT/CST provisions, stock transfers are also included in the turnover whereas stock transfer is not part of turnover as for generally accepted accounting principles.

(iv) **Evaluation of internal control etc.:** Before determining the extent of audit checks to be applied i.e. whether to go in- depth or to do only test check, the auditor should ascertain whether there is an internal check system in operation in the entity. He should particularly find out how the purchases and sales gets initiated. For example, in case of purchase, receipt of indent by the purchase department, determining the need for purchases, initiation of purchase order, receipt of material, preparation of MRN, entries made in the books of accounts etc. should be verified. For sales, receipt of inquiry, acceptance of sales order, execution of sales, preparation of sale invoice and realization of transaction. If the internal control is reliable, the extent of audit may be reduced and should be focused only on those areas where the auditor feels that greater degree of audit risk is involved.

(v) **Knowledge about the VAT law and allied laws:** The auditor and his staff should obtain a thorough knowledge of the State VAT law under which the audit is to be conducted. The auditor should study the VAT law starting from the definition of various terms, the procedure to be adopted, the provisions regarding issue of invoices, claiming of input tax credit, composition schedule in the VAT law, the manner in which the output tax is to be calculated the provisions of audit, the contents of the audit report, the periodicity of the return to be filed, the format of the forms of returns, and the various notifications issued. Further the auditor should know the Central Sales-tax law as he has to comment on the liability under that law also. The auditor should also have some knowledge about the judicial pronouncements made by the Tribunals and the Courts on the various facets of these laws.

Question 8

Write a short note on - Accounting ratios in Form 3CD of Tax Audit.

Answer

Accounting Ratios in Form 3CD of Tax Audit: Details regarding turnover, gross profit, etc., for the previous year and preceding previous year should be provided as follows:

Serial Number	*Particulars*	*Previous year*	*Preceding Previous year*
1.	***Total turnover of the assessee***		
2.	***Gross profit/turnover***		
3.	***Net profit/turnover***		
4.	***Stock-in-trade/turnover***		
5.	***Material consumed/finished goods produced***		

The details required to be furnished for principal items of goods traded or manufactured or services rendered. These ratios have to be calculated only for assessees who are engaged in manufacturing or trading activities. This clause is not applicable to assessees carrying on profession. Moreover, the ratios have to be given for the business as a whole and need not be given product wise.

Question 9

What is your understanding about the term "Audit of Indirect Taxes"? Explain the steps involved in the Indirect Tax Audit.

Answer

Audit of Indirect Taxes: The components of central indirect tax which form a part of the cost could be basic customs duty, additional duty of customs, special additional duty, excise duty special excise duty, additional duties of excise, service tax etc. The various components have a relationship with each other and also with central and local sales tax. The audits in this area, are governed under sections 14A and 14AA of the Central Excise Act, 1944. All these audits are conducted by or on behalf of the Government. The steps involved in conducting indirect tax audit are as under:

(i) Evaluate the internal control systems in general with specific weight given to the strength of the systems in aiming at the quantification and discharge of the indirect taxes. The auditor should ensure that the accounting system and related internal control in this area are covered appropriately. Internal control questionnaire may be designed specifically for the area of indirect taxation.

(ii) Obtains information about the company and the industry. Specific information on amount of imports, percentage of customs, amount of removals, and quantum of Cenvat-proportion of credit could also be calculated. The walk through of the process from the point of ordering of materials till the receipt of the payment from the customer is advisable.

(iii) Formulating an audit programme to assist in the actual conduct of the audit. The actual extent of verification would be dependent on the results of the evaluation of the internal controls.

(iv) Ensure that the audit staff is knowledgeable in the law and the procedures governing the indirect taxes. The examination of the documents, physical verification, reconciliation tracing techniques, comparison of ratios, observation of the activities and discussions of the weaknesses observed should be part of an effective audit.

(v) Prepare a report on the indirect tax audit providing specific comments on the statutory information, material matters reported by way of an executive summary and the assertion/qualification that the acceptable accounting policies are in vogue.

Question 10

Enumerate some of the areas of concern in an audit of indirect taxes.

Answer

Audit of Indirect Taxes: Some areas of concern in an audit of indirect taxes would be:

(i) Non availment or short / excess availment of export incentives.

(ii) Goods imported duty free or payment at concessional rates without properly complying with conditions.

(iii) Valuation Issues – valuation not in line with customs rules.

(iv) Applicability of the relevant export /excise exemptions.

(v) Valuation of goods not removed in normal course using valuation methods not in line with Central Excise Valuation Rules.

(vi) Ignoring Liability under Service Tax on services provided or availed.

(vii) Procedural non-compliance.

(viii) Passing on of duty suffered on imported goods and of locally manufactured goods in excess of actual.

(ix) Utilisation / Availability of credit of duty/ tax paid on inputs, capital goods of input services.

Questions 11

State whether a Tax audit report can be revised and if so state those circumstances.

Answer

Revision of Tax Audit Report:

(a) Normally, the report of the tax auditor cannot be revised later.

(b) 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 it 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.

Question 12

Draft an Audit programme for conducting the audit of a Public Trust registered under section 12A of the Income-tax Act, 1961.

Answer

An auditor should conduct routine checking during the course of audit of a public trust, in the following manner:

(i) Check the books of account and other records having regard to the system of accounting and internal control

(ii) Vouch the transactions of the trust to satisfy that:

(a) the transaction falls within the ambit of the trust

(b) the transaction is properly authorized by the trustees or other delegated authority as may be permissible in law;

(c) all incomes due to the trust have been properly accounted for on the basis of the system of accounting followed by the trust;

(d) all expenses and outgoings appertaining to the trust have been recorded on the basis of the system of accounting followed by the trust;

(e) amounts shown as applied towards the object of the trust are covered by the objects of trust as specified in the document governing the trust.

(iii) Obtain trial balance on the closing date certified by the trustees' duly certified by the trustee;

(iv) Obtain Balance Sheet and Profit & Loss Account of the trust authenticated by the trustees and check the same with the trial balance with which they should agree.

Question 13

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?

Answer

Compliance of Section 145: 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 ASs are corresponding to AS-1 and AS-5 respectively issued by the ICAI. As per Section 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 ***clause 13(a)*** of form 3CD. ***Further, Form No. 3CD vide clause 13(d)***

requires reporting of the details of deviation, if any, in the method of accounting employed in the previous year from accounting standards prescribed under section 145 and the effect thereof on the profit or loss.

(b) ***Accounting policies as required by AS (IT) -1 has been disclosed separately.***

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

Question 14

'A' Limited has paid minimum alternate tax under Section 115 JB of the Income-tax Act, 1961, for the year ended 31st March, 2012. The company wants to disclose the same as an 'Asset' since the company is eligible to claim credit for the same. Comment.

Answer

As per Para 6 of the Guidance Note issued by ICAI on "Accounting for credit available in respect of MAT under the IT Act, 1961", although MAT credit is not a deferred tax asset under AS 22, yet it gives rise to expected future economic benefit in the form of adjustment of future income tax liability arising within the specific period.

The Framework for the preparation and presentation of financial statements, issued by the ICAI, defines the term 'asset' is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

MAT paid in a year in respect of which the credit is allowed during the specified period under the Income-tax Act, 1961 is a resource controlled by the company as a result of past event, namely the payment of MAT. The MAT credit has expected future economic benefits in the form of its adjustment against the discharge of the normal tax liability if the same arises during the specified period. Accordingly, such credit is an asset.

According to the Framework, once an item meets the definition of the term 'Asset', it has to meet the criteria for recognition of an asset, so that it may be recognised as such in the financial statements.

Para 88 of the Framework provide the following criteria for recognition of an asset:

An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

In addition to the above, the auditor shall take a confirmation letter from the assessee for the said facts.

Thus, if the auditor is satisfied that the probability of the company to claim the said credit is high, it could recognise the same as an asset.

Question 15

Answer the following:

(a) ABC Printing Press, a proprietary concern, made a turnover of above ₹ 1.03 crore for the year ended 31.03.2014. The Management explained its auditor Mr. Z, that it undertakes different job work orders from customers. The raw materials required for every job are dissimilar. It purchases the raw materials as per specification/requirements of each customer, and there is hardly any balance of raw materials remaining in the stock, except pending work-in-progress at the year end. Because of variety and complexity of materials, it is rather impossible to maintain a stock-register. Give your comments.

(b) A Co-operative Society having receipts above ₹ 1 crore gets its accounts audited by a person eligible to do audit under Co-operative Societies Act, 1912, who is not a Chartered Accountant. State with reasons whether such audit report can be furnished as tax audit report under Section 44AB of the Income-tax Act, 1961?

Answer

(a) Non-maintenance of stock register: The explanation of the entity for the use of varieties of raw materials for different jobs undertaken may be valid. But the auditor needs to verify the specified job-orders received and the different raw materials purchased for each job separately. The use of different papers (quality, quantity and size) ink, colour etc. may be examined. If possible, the auditor may also enquire with the other similar printers in the locality to ensure the prevailing custom. At the same time, he has to report and certify under the clause 35(b) and clause 11(b) of Form 3CD read with the Rule 6G(2) of the Income-tax Act, 1961, about the details of stock and account books (including stock register) maintained. He (or his deputy) must verify the closing stock of raw materials, work-in-progress and finished goods of the concern, at least on the date of its balance sheet. In case the said details are not properly maintained, he has to specifically mention the same with reasons for non-maintenance of stock register by the entity.

(b) Furnishing Audit Report of a Co-operative Society: As per Section 44AB read with Explanation to Section 288(2) of the Income Tax Act, 1961, "accountant" means a chartered accountant within the meaning of the Chartered Accountants Act, 1949, and includes, in relation to any State, any person who by virtue of the provisions of section 141 of the Companies Act, 2013, is entitled to be appointed to act as an auditor of companies registered in that State.

Accordingly, the person who is not a Chartered Accountant as mentioned in the question, though is eligible to act as auditor of Cooperative Society under the Cooperative Society Act, 1912, but is not eligible to carry out tax audit under Section 44AB of the Income Tax Act, 1961.

Hence, such audit report cannot be furnished as tax audit report under Section 44AB of the Income-tax Act, 1961.

Question 16

Discuss briefly Accounting standards to be followed by assessees under the Income-tax Law.

Answer

Accounting Standards under the Income Tax Law: The Finance Act, 1995, substituted a new Section 145 w.e.f. 1997-98. The section deals with method of accounting as under:

145 (1) Income chargeable under the head 'Profit and gains of business and profession' or 'Income from other sources' shall, subject to the provisions of sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.

145 (2) The Central Government may notify in the Official Gazette from time to time accounting standards to be followed by any class of assessees or in respect of any class of income.

145 (3) Where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the assessee, or where method of accounting provided in the Sub-section 10 or accounting standards as notified under Section (2) above have not been regularly followed by the assessee. The Assessing Officer may make an assessment in a manner provided in Section 144 of the Income-tax Act, 1961.

The Central Government has by Notification No. S. O. 69 (E), dated 25.01.1996, prescribed. AS (IT) as under:

A. Accounting Standard I relating to Disclosure of accounting policies.

B. Accounting Standard II relating to Disclosure of Prior Period and Extraordinary Items and Changes in Accounting Policies.

The above Accounting Standards are to be followed by all assessee following mercantile system of accounting. Therefore, it is clear that those assessees who are following cash system of accounting need not follow the Accounting Standards notified above.

Question 17

T Ltd. an Indian company, subject to Indian Income tax Act, 1961, discloses advance Income-tax paid (Current tax asset) and provision for Income-tax (Current tax liability), separately in Balance Sheet for the year ended 31.3.2014, i.e., it does not offset the amount. Comment.

Answer

As per paragraph 27 of Accounting Standard (AS) 22 – Accounting for Taxes on Income, an enterprise should offset assets and liabilities representing current tax if the enterprise:

(i) has a legally enforceable right to set off the recognized amounts and

(ii) intends to settle the asset and liability on a net basis.

An enterprise will normally have a legally enforceable right to set off an asset and liability representing current tax when they relate to income taxes levied under the same governing taxation laws and the taxation laws permit the enterprise to make or receive a single net payment.

Since T Ltd. is an Indian Company, and as per Income Tax Act, 1961, such set off is allowed which is legally enforceable. Thus, in view of Provisions of AS 22 and Income Tax Laws, T Ltd. should off set advance tax paid against provision for income tax and show only the net amount in the balance sheet.

Question 18

Mr. R, the Tax Auditor finds that some payments inadmissible under Section 40A(3) were made, and advised the client to report the same in form 3CD. The client contends that cash payments were made since the other parties insisted upon the same and did not have Bank Accounts. Comment.

Answer

Form 3CD: The audit under section 44AB of the Income Tax Act 1961 requires that the tax auditor should report whether in his opinion the particulars in respect of Form 3CD are true and correct. It is the primary responsibility of the assessee to prepare the information in form 3CD. The auditor has to examine whether the information given is true and correct. The form 3CD is not a report of Tax Auditor. The report is in the form of 3CA or 3CB depending on the nature of the organization of the entity. If the tax auditor is satisfied that the information contained in form 3CD is true and correct then he can give unqualified report in form 3CA or 3CB saying" in my opinion and to the best of my information and according to the explanations given to me and considering the materiality the particulars given in form 3CD are true and correct." But in the given case the tax auditor has found that the form 3CD contains the incomplete, misleading and false information.

Disallowance under section 40A(3) is attracted if the assessee incurs any expenses in respect of which payment of aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on bank or account payee draft exceeds ₹20,000. However, exemption is provided in respect of certain expenditure in Rule 6DD. In such cases, disallowance under section 40A(3) would not be attracted.

Under clause 21(d)(A) of Form 3CD, the tax auditor has to scrutinize on the basis of the examination of books of account and other relevant documents/evidence, whether the expenditure covered under section 40A(3) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, the same has to be reported under abovementioned clause.

Cash payment made on insistence of other parties on the contention that they do not have bank accounts is not covered under the list of exceptions provided under Rule 6DD. Therefore, Mr. R has to report the payments inadmissible under section 40A(3) under clause 21(d)(A) of Form 3CD.

Question 19

While conducting the tax audit of A & 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?

Answer

Clause 16(c) of Form 3CD: A tax auditor has to report under ***clause 16(c)*** of Form 3CD on any escalation claim accepted during the previous year and not credited to the profit and loss account under ***clause 16(c)*** of Form 3CD.

The escalation claim accepted during the year would normally mean "accepted during the relevant previous year". If such amount are 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.

Question 20

As a tax auditor how would you deal and report the following:

(i) An assesses has borrowed ₹ 50 lakhs from various persons. Some of them by way of cash and some of them by way of Account payee cheque /Draft.

(ii) An assesses has paid Rent to his brother ₹ 2,50,000/- and paid interest to his sister ₹ 4,00,000/-.

Answer

(i) Borrowal of ₹ 50 Lakhs: As per Clause 31 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 31(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 31(c) the tax auditor has to state whether the taking or accepting loan or deposit, or repayment of the same were made by account payee cheque drawn on a bank or account payee bank draft based on the examination of books of account and other relevant documents. Furthermore, the tax auditor has the responsibility 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 31 of Form 3CD.

(ii) Payment of Rent and Interest: A tax auditor has to report under Clause 23 of Form 3CD which deals with the particulars of payments made to persons specified under Section 40A(2)(b) of the Income Tax Act, 1961. Where the assessee is an individual, the specified persons include any relative of the assessee (i.e. 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 which 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.

Question 21

As an auditor of a partnership firm under section 44AB of the Income Tax Act, 1961, how would you report on the following:

(i) Capital expenditure incurred for scientific research assets

(ii) Expenditure incurred at clubs.

Answer

(i) Capital Expenditure incurred for Scientific Research Assets: Expenditure on Scientific Research (capital as well as revenue) covered under section 35 of the Income-Tax Act, 1961, is to be reported by a tax auditor under clause 19 of Form 3CD. The tax auditor is required to report the following:

(a) amount debited to the profit and loss account, and

(b) amounts admissible as per the provisions of the Income-tax Act, 1961 and also fulfils the conditions, if any specified under the relevant provisions of Income-tax Act, 1961 or Income-tax Rules, 1962 or any other guidelines, circular, etc., issued in this behalf.

(ii) Payment to Club: As per Clause 21(a) of Form 3CD, the amount of expenditure incurred at clubs by the assessee during the year being entrance fees and subscriptions, and being cost for club services and facilities used should be indicated.

The payments made may be 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. The tax auditor is required to furnish the details of

amounts debited to the profit and loss account, being in the nature of capital, personal, advertisement expenditure etc.

Question 22

While writing the audit program for tax audit in respect of A Ltd., you wish to include possible instances of capital receipt if not credited to Profit & Loss Account which needs to be reported under clause 16(e) of form 3CD. Please elucidate possible instances.

Answer

The following is an illustrative list of capital receipts which, if not credited to the profit and loss account, are to be stated under clause 16(e) of Form 3CD-

(a) Capital subsidy received in the form of Government grants, which are in the nature of promoters' contribution i.e., they are given with reference to the total investment of the undertaking or by way of contribution to its total capital outlay. For e.g., Capital Investment Subsidy Scheme.

(b) Government grant in relation to a specific fixed asset where such grant is shown as a deduction from the gross value of the asset by the concern in arriving at its book value.

(c) Compensation for surrendering certain rights.

(d) Profit on sale of fixed assets/investments to the extent not credited to the profit and loss account.

Question 23

As the tax auditor of a Company, how would you report on payments exceeding ₹ 20,000 made in cash to a supplier against an invoice for expenses booked in an earlier year?

Answer

Reporting of payments exceeding ₹ 20000 in cash: Such reporting is required to be done while conducting the tax audit u/s 44AB of the Income Tax Act, 1961 in Form 3CD. The tax auditor shall have to report under clause 21(d)(B) for the above as per the section 40A(3A) of the Income Tax Act, 1961 i.e. where an allowance has been made in the assessment for any year in respect of any liability incurred by the assessee for any expenditure and subsequently during any previous year the assessee makes payment in respect thereof, otherwise than by an account payee cheque drawn on a bank or account payee bank draft, the payment so made shall be deemed to be the profits and gains of business or profession and accordingly chargeable to income-tax as income of the subsequent year if the payments made to a person in a day, exceeds twenty thousand rupees.

In the instant case, the invoice for expenses has been booked in an earlier year. However, since payment for the same is made during the current year by cash exceeding ₹ 20000, the reporting thereof would be necessary in clause 21(d)(B) of Form 3CD. The sub-clause (d)(B) required furnishing of the amount inadmissible under section 40A(3A) read with rule 6DD along with computation.

The entire amount paid as above, is likely to be disallowed under section 40A(3A) of the Income Tax Act, 1961.

Question 24

Mr. A engaged in business as a sole proprietor presented the following information to you for the FY 13-14. Turnover made during the year ₹ 124 lacs. Goods returned in respect of sales made during FY 11-12 is ₹ 20 lacs not included in the above. Cash discount allowed to his customers ₹ 1 lac for prompt payment. Special rebate allowed to customer in the nature of trade discount ₹ 5 lacs. Kindly advice him whether he has to get his accounts audited u/s 44AB of the Income Tax Act, 1961.

Answer

Turnover limit for the purpose of Tax Audit: The following points merit consideration as stated in the Guidance note on Tax Audit issued by the Institute of Chartered Accountants of India-

(i) Price of goods returned should be deducted from the figure of turnover even if the return are from the sales made in the earlier years.

(ii) Cash discount otherwise than that allowed in a cash memo/sales invoice is in the nature of a financing charge and is not related to turnover. The same should not be deducted from the figure of turnover.

(iii) Special rebate allowed to a customer can be deducted from the sales if it is in the nature of trade discount.

Applying the above stated points to the given problem,

1.	*Total Turnover*	*124 Lacs*
2.	*Less – (i) Goods Returned*	*20 Lacs*
	(ii) Special rebate allowed to customer in the nature of trade discount would be deducted	*5 Lacs*
	Balance	*99 Lacs*

As the limit for tax audit is ₹ one crore, therefore, he would not be required to get his accounts audited under section 44AB of the Income Tax Act, 1961.

Question 25

Concession Ltd. is engaged in the business of manufacturing of threads. The company recorded the turnover of ₹ 1.13 crore during the financial year 2013-14 before adjusting the following:

Discount allowed in the Sales Invoice	*₹ 8,20,000*
Cash discount (other than allowed in	
Cash memo/ sales invoice)	*₹ 9,20,000*
Trade discount	*₹ 2,90,000*
Commission on Sales	*₹ 6,00,000*
Sales Return (F.Y. 2012-13)	*₹ 1,60,000*
Sale of Investment	*₹ 6,60,000*

You are required to ascertain the effective turnover to be considered for the prescribed limit of tax audit under the relevant Act and guide the company whether the provisions relating to tax audit applies.

Answer

The provisions relating to tax audit under section 44AB of the Income Tax Act, 1961 applies to every person carrying on business, if his total sales, turnover or gross receipts in business exceed the prescribed limit of ₹ 1 crore (w.e.f. A.Y. 2013-14) and to a person carrying on a profession, if his gross receipts from profession exceed the prescribed limit of ₹ 25 lakhs (w.e.f. A.Y. 2013-14) in any previous year. However, the term "sales", "turnover" or "gross receipts" are not defined in the Act, and therefore the meaning of the aforesaid terms has to be considered for the applicability of the section.

Some of the merit consideration in this regard as discussed in the Guidance Note issued by the Institute are given below-

(i) Discount allowed in the sales invoice will reduce the sale price and, therefore, the same can be deducted from the turnover.

(ii) Cash discount otherwise than that allowed in a cash memo/sales invoice is in the nature of a financing charge and is not related to turnover. Therefore, should not be deducted from the turnover.

(iii) Turnover discount is normally allowed to a customer if the sales made to him exceed a particular quantity. As per trade practice, it is in the nature of trade discount and should be deducted from the figure.

(iv) Special rebate allowed to a customer can be deducted from the sales if it is in the nature of trade discount. If it is in the nature of commission on sales, the same cannot be deducted from the figure of turnover.

(v) Price of goods returned should be deducted from the turnover even if the returns are from the sales made in the earlier year/s.

(vi) Sale proceeds of any shares, securities, debentures, etc., held as investment will not form part of turnover. However if the shares, securities, debentures etc., are held as stock-in-trade, the sale proceeds thereof will form part of turnover.

In the given case, Concession Ltd. is engaged in manufacturing business. Therefore, the tax audit would be applicable if the turnover exceeds ₹ 1 crore during the financial year 2013-14. The calculation of effective turnover for the prescribed limit purpose, in accordance with abovementioned conditions, is given below:

Recorded turnover during the year	*₹ 1,13,00,000*
Less: (i) Discount allowed in the Sales Invoice	*(₹ 8,20,000)*
(ii) Trade discount	*(₹ 2,90,000)*
(iii) Sales Return	*(₹ 1,60,000)*
Effective turnover	*₹ 1,00,30,000*

The effective turnover of Concession Ltd. is Rupees one crore and thirty thousand only which is over and above the prescribed limit for tax audit under section 44AB of the Income tax Act, 1961. Thus, the provisions related to tax audit are applicable to the company and is therefore liable for tax audit.

15

Audit under Fiscal Laws

Question 1

Mr. A engaged in business as a sole proprietor presented the following information to you for the FY 12-13. Turnover made during the year ₹ 124 lacs. Goods returned in respect of sales made during FY 10-11 is ₹ 20 lacs not included in the above. Cash discount allowed to his customers ₹ 1 lac for prompt payment. Special rebate allowed to customer in the nature of trade discount ₹ 5 lacs. Kindly advice him whether he has to get his accounts audited u/s 44AB of the Income Tax Act, 1961. *(4 Marks, November, 2013)*

Answer

Turnover limit for the purpose of Tax Audit: The following points merit consideration as stated in the Guidance note on Tax Audit issued by the Institute of Chartered Accountants of India-

(i) Price of goods returned should be deducted from the figure of turnover even if the return are from the sales made in the earlier years.

(ii) Cash discount otherwise than that allowed in a cash memo/sales invoice is in the nature of a financing charge and is not related to turnover. The same should not be deducted from the figure of turnover.

(iii) Special rebate allowed to a customer can be deducted from the sales if it is in the nature of trade discount.

Applying the above stated points to the given problem,

1.	Total Turnover	124 Lacs
2.	Less – (i) Goods Returned	20 Lacs
	(ii) Special rebate allowed to customer in the nature of trade discount would be deducted.	5 Lacs
	Balance	99 Lacs

As the limit for tax audit is ₹ one crore, therefore, he would not be required to get his accounts audited under section 44AB of the Income Tax Act, 1961.

Question 2

While writing the audit program for tax audit in respect of A Ltd you wish toinclude possible instances of capital receipt if not credited to Profit & Loss Account which needs to be reported under clause 13(e) of form 3CD. Please elucidate possible instances.

(4 Marks, May, 2013)

Answer

This question is redundant in view of the latest Form 3CD issued dated 25th July, 2014.

Question 3

As an auditor of a partnership firm under section 44AB of the Income Tax Act, 1961, how would you report on the following:

(i) Capital expenditure incurred for scientific research assets.

(2 Marks, November, 2012) (4 Marks, May, 2006)

(ii) Expenditure incurred at clubs. *(2 Marks, November, 2012)*

Answer

(i) Capital Expenditure incurred for Scientific Research Assets: Expenditure on Scientific Research (capital as well as revenue) covered under section 35 of the Income-Tax Act, 1961, is to be reported by a tax auditor under clause 19 of Form 3CD. The tax auditor is required to report the following:

(i) amount debited to the profit and loss account, and

(ii) amounts admissible as per the provisions of the Income-tax Act, 1961 and also fulfils the conditions, if any specified under the relevant provisions of Income-tax Act, 1961 or Income-tax Rules, 1962 or any other guidelines, circular, etc., issued in this behalf.

(ii) Payment to Club: As per Clause 21(a) of Form 3CD, the amount of expenditure incurred at clubs by the assessee during the year being entrance fees and subscriptions, and being cost for club services and facilities used should be indicated.

The payments made may be 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. The tax auditor is required to furnish the details of amounts debited to the profit and loss account, being in the nature of capital, personal, advertisement expenditure etc.

Question 4

T Ltd's previous year ended on 31st March 2012. During that period it made a claim for refund of customs duty which was admitted as due by the customs authorities during April 2012. T Ltd neither credited the claim in the profit and loss account nor reported the same in clause 13(b) of Form 3CD for the reason that this has been admitted as due by the authorities only in the next financial year. Further T Ltd had changed the method of determination of cost formula

for the purpose of stock valuation from FIFO basis to Weighted Average Cost basis, but that was also not reflected in clause I1(b) of Form 3CD which requires reporting on change in accounting method employed. Comment. *(6 Marks, May, 2012)*

Answer

This question is redundant in view of the latest Form 3CD issued dated 25th July, 2014.

Question 5

Briefly explain the steps involved in Audit under Indirect Tax. *(8 Marks, November, 2011)*

Answer

Steps involved in Audit under Indirect Taxes: The components of central indirect tax which form a part of the cost could be basic customs duty, additional duty of customs, special additional duty, excise duty special excise duty, additional duties of excise, service tax etc. The various components have a relationship with each other and also with central and local sales tax. The audits in this area are governed under sections 14A and 14AA of the Central Excise Act, 1944. All these audits are conducted by or on behalf of the Government. The steps involved in conducting indirect tax audit are as under:

(i) Evaluate the internal control systems in general with specific weight given to the strength of the systems in aiming at the quantification and discharge of the indirect taxes. The auditor should ensure that the accounting system and related internal control in this area are covered appropriately. Internal control questionnaire may be designed specifically for the area of indirect taxation.

(ii) Obtains information about the company and the industry. Specific information on amount of imports, percentage of customs, amount of removals, and quantum of Cenvat-proportion of credit could also be calculated. The walk through of the process from the point of ordering of materials till the receipt of the payment from the customer is advisable.

(iii) Formulating an audit programme to assist in the actual conduct of the audit. The actual extent of verification would be dependent on the results of the evaluation of the internal controls.

(iv) Ensure that the audit staff is knowledgeable in the law and the procedures governing the indirect taxes. The examination of the documents, physical verification, reconciliation tracing techniques, comparison of ratios, observation of the activities and discussions of the weaknesses observed should be part of an effective audit.

(v) Prepare a report on the indirect tax audit providing specific comments on the statutory information, material matters reported by way of an executive summary and the assertion/qualification that the acceptable accounting policies are in vogue.

Question 6

As a tax auditor how would you deal and report the following:

(i) An assesses has borrowed ₹ 50 lakhs from various persons. Some of them by way of cash and some of them by way of Account payee cheque /Draft.

(ii) An assesses has paid Rent to his brother ₹ 2,50,000/- and paid interest to his sister ₹ 4,00,000/-

(iii) An assesses has incurred payment to clubs. *(3+2+2=7 Marks, November, 2011)*

Answer

Tax Audit Report

(i) Borrowal of ₹ 50 Lakhs : As per Clause 31 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 31(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 31(c) the tax auditor has to state whether the taking or accepting loan or deposit, or repayment of the same were made by account payee cheque drawn on a bank or account payee bank draft based on the examination of books of account and other relevant documents. Furthermore, the tax auditor has the responsibility 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 31 of Form 3CD.

(ii) Payment of Rent and Interest: A tax auditor has to report under Clause 23 of Form 3CD which deals with the particulars of payments made to persons specified under Section 40A(2)(b) of the Income Tax Act, 1961. Where the assessee is an individual, the specified persons include any relative of the assessee (i.e. 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 which 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 21(a) of Form 3CD the amount of expenditure incurred at clubs by the assessee during the year being entrance fees and subscriptions, and being cost for club services and facilities used should be indicated.

The payments made may be 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. The tax auditor is required to furnish the details of amounts debited to the profit and loss account, being in the nature of capital, personal, advertisement expenditure etc.

Question 7

While conducting the tax audit of A & 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? *(4 Marks, May, 2011)*

Answer

Clause 16(c) of Form 3 CD: A tax auditor has to report under clause 16(c) of Form 3CD on any escalation claim accepted during the previous year and not credited to the profit and loss account under clause 16(c) of Form 3CD.

The escalation claim accepted during the year would normally mean "accepted during the relevant previous year." If such amount are 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.

Question 8

Mr. R, the Tax Auditor finds that some payments inadmissible under Section 40A(3) were made, and advised the client to report the same in form 3CD. The client contends that cash payments were made since the other parties insisted upon the same and did not have Bank Accounts. Comment. *(5 Marks, November, 2010)*

Answer

Form 3CD: The audit under section 44AB of the Income Tax Act 1961 requires that the tax auditor should report whether in his opinion the particulars in respect of Form 3CD are true and correct. It is the primary responsibility of the assessee to prepare the information in form 3CD. The auditor has to examine whether the information given is true and correct. The form 3CD is not a report of Tax Auditor. The report is in the form of 3CA or 3CB depending on the nature of the organization of the entity. If the tax auditor is satisfied that the information contained in form 3CD is true and correct then he can give unqualified report in form 3CA or 3CB saying" in my opinion and to the best of my information and according to the explanations given to me and considering the materiality the particulars given in form 3CD are true and correct." But in the given case the tax auditor has found that the form 3CD contains the incomplete, misleading and false information.

Disallowance under section 40A(3) is attracted if the assessee incurs any expenses in respect of which payment of aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on bank or account payee draft exceeds ₹ 20,000. However, exemption is provided in respect of certain expenditure in Rule 6DD. In such cases, disallowance under section 40A(3) would not be attracted.

Under clause 21(d)(A) of Form 3CD, the tax auditor has to scrutinize on the basis of the examination of books of account and other relevant documents/evidence, whether the expenditure covered under section 40A(3) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, the same has to be reported under abovementioned clause.

Cash payment made on insistence of other parties on the contention that they do not have bank accounts is not covered under the list of exceptions provided under Rule 6DD. Therefore, Mr. R has to report the payments inadmissible under section 40A(3) under clause 21(d)(A) of Form 3CD.

Question 9

Write short notes on Major steps required in preparation of Tax audit under VAT.

(5 Marks, May, 2010)

Or

What are the steps for the Audit under the State level 'Value Added Tax' (VAT)?

(8 Marks, November, 2007)

Answer

Major steps required for Tax audit under VAT: VAT is a tax on the value added to the commodity at each stage in the production and distribution chain. VAT is an indirect Tax on consumption. It is a tax on the value at the retail point of sale which is collected at each stage of sale. The essence of VAT is that it provides credit set off for input tax i.e. tax paid on purchases against the output tax i.e. tax payable on sales. A tax auditor has to make certain preliminary preparations before the actual execution of tax audit under the VAT law. The major steps required to be undertaken for the preparation are as under:

(i) Knowledge of business: After accepting the audit assignment the auditor should familiarize himself with the business of the auditee. In this regard, the auditor should refer to the SA 315 - "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment" issued by the Council of the Institute of Chartered Accountants of India. Before starting the audit, the auditor should

have a preliminary knowledge of the industry/ business and of the nature of ownership, management etc. More detailed information should be obtained and should be assessed and updated during the course of audit. For this purpose the various sources of information may be tapped. The knowledge of business is important not only to the auditor but also to his staff engaged in the audit. The auditor has to ensure that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to carry out the audit work delegated to them and further they should make effective use of the knowledge about the business and should consider how it affects the tax liability reported in the return. The facts and figures in the returns should be consistent with the auditor's knowledge of the business. The auditor should also make himself familiar with the process of production and the distribution chain. The auditor should also obtain information about whether the auditee is a manufacturer/ importer/ retailer, the details of major customers to whom the sales are effected and the details of sales which are outside the scope of VAT law. Similarly the sources of purchase and the items sold should be listed out. Further it should be ascertained whether the auditee has opted for the composition scheme or not.

(ii) Obtaining a list of all the accounting records maintained by the auditee: The auditor should obtain a complete list of all the accounting records relating to sale/purchase of goods, stocks, the various registers, the ledgers etc. maintained, in which the transactions are recorded, the various source documents in which the entries are recorded in the books of account and the process of their generation.

(iii) Ascertaining the major accounting policies adopted by the auditee: The auditor should know the major accounting polices based on which books of account have been recorded. The accounting policy regarding recording of sales, purchases and valuation of inventory must be made known and the auditor should also find out whether there has been any change in those policies during the year covered by audit. If there is any significant change in the accounting policy giving rise to some material effect on the tax liability, the same should be invariably reported.

(iv) Evaluation of internal control etc.: Before determining the extent of audit checks to be applied i.e. whether to go in- depth or to do only test check, the auditor should ascertain whether there is an internal check system in operation in the entity. He should particularly find out how the purchases and sales gets initiated. For example, in case of purchase, receipt of indent by the purchase department, determining the need for purchases, initiation of purchase order, receipt of material, preparation of MRN, entries made in the books of accounts etc. should be verified. For sales, receipt of inquiry, acceptance of sales order, execution of sales, preparation of sale invoice and realization of transaction. If the internal control is reliable, the extent of audit may be reduced and should be focused only on those areas where the auditor feels that greater degree of audit risk is involved.

(v) Knowledge about the VAT law and allied laws: The auditor and his staff should obtain a thorough knowledge of the State VAT law under which the audit is to be conducted. The auditor should study the VAT law starting from the definition of various terms, the procedure to be adopted, the provisions regarding issue of invoices, claiming of input tax credit, composition schedule in the VAT law, the manner in which the output tax is to be calculated the provisions of audit, the contents of the audit report, the periodicity of the return to be filed, the format of the forms of returns, and the various notifications issued. Further the auditor should know the Central Sales-tax law as he has to comment on the liability under that law also. The auditor should also have some knowledge about the judicial pronouncements made by the Tribunals and the Courts on the various facets of these laws.

Question 10

(a) ABC Printing Press, a proprietary concern, made a turnover of above ₹43 lacs for the year ended 31.03.2009. The Management explained its auditor Mr. Z, that it undertakes different job work orders from customers. The raw materials required for every job are dissimilar. It purchases the raw materials as per specification/requirements of each customer, and there is hardly any balance of raw materials remaining in the stock, except pending work-in-progress at the year end. Because of variety and complexity of materials, it is rather impossible to maintain a stock-register. Give your comments.

(5 Marks, November, 2009)

(b) A Co-operative Society having receipts above ₹40 lakhs gets its accounts audited by a person eligible to do audit under Co-operative Societies Act, 1912, who is not a Chartered Accountant. State with reasons whether such audit report can be furnished as tax audit report under Section 44 AB of the Income Tax Act, 1961?

(3 Marks, November, 2009)

Answer

(a) This question is redundant in view of the latest provisions regarding applicability of tax audit.

(b) This question is redundant in view of the latest provisions regarding applicability of tax audit.

Question 11

Discuss briefly Accounting standards to be followed by assessees under the Income-tax Law. *(4 Marks, November, 2009)*

Answer

Accounting Standards under the Income Tax Law: The Finance Act, 1995, substituted a new Section 145 w.e.f. 1997-98. The section deals with method of accounting as under:

145(1) Income chargeable under the head 'Profit and gains of business and profession' or 'Income from other sources' shall, subject to the provisions of sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.

145(2) The Central Government may notify in the Official Gazette from time to time accounting standards to be followed by any class of assessees or in respect of any class of income.

145(3) Where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the assessee, or where method of accounting provided in the Sub-section 10 or accounting standards as notified under Section (2) above have not been regularly followed by the assessee. The Assessing Officer may make an assessment in a manner provided in Section 144 of the Income Tax Act.

The Central Government has by Notification No. S. O. 69 (E), dated 25.01.1996, prescribed. AS (IT) as under:

A. Accounting Standard I relating to Disclosure of accounting policies.

B. Accounting Standard II relating to Disclosure of Prior Period and Extraordinary Items and Changes in Accounting Policies.

The above Accounting Standards are to be followed by all assessee following mercantile system of accounting. Therefore, it is clear that those assessees who are following cash system of accounting need not follow the Accounting Standards notified above.

Question 12

Draft an Audit programme for conducting the audit of a Public Trust registered under section 12A of the Income Tax Act, 1961. *(8 Marks, June, 2009)*

Answer

An auditor should conduct routine checking during the course of audit of a public trust, in the following manner:

(i) Check the books of account and other records having regard to the system of accounting and internal control.

(ii) Vouch the transactions of the trust to satisfy that:

  (a) the transaction falls within the ambit of the trust;

  (b) the transaction is properly authorized by the trustees or other delegated authority as may be permissible in law;

  (c) all incomes due to the trust have been properly accounted for on the basis of the system of accounting followed by the trust;

  (d) all expenses and outgoings appertaining to the trust have been recorded on the basis of the system of accounting followed by the trust;

  (e) amounts shown as applied towards the object of the trust are covered by the objects of trust as specified in the document governing the trust.

(iii) Obtain trial balance on the closing date certified by the trustees' duty certified by the trustee;

(iv) Obtain Balance Sheet and Statement of Profit and Loss of the trust authenticated by the trustees and check the same with the trial balance with which they should agree.

Question 13

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?

(8 Marks, June, 2009)

Answer

Compliance of Section 145: 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 respectively issued by the ICAI. As per Section 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 13(a) of form 3CD. Further, Form No. 3CD *vide* clause 13(d) requires reporting of the details of deviation, if any, in the method of accounting employed in the previous year from accounting standards prescribed under section 145 and the effect thereof on the profit or loss.

(b) Accounting policies as required by AS (IT) -1 has been disclosed separately.

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

Question 14

State whether a Tax audit report can be revised and if so state those circumstances.

(4 Marks, November, 2008)

Answer

Revision of Tax Audit:

(a) Normally, the report of the tax auditor cannot be revised later.

(b) 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 it 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.

Question 15

As the tax auditor of a Company, how would you report on payments exceeding ₹ 20,000 made in cash to a supplier against an invoice for expenses booked in an earlier year?

(5 Marks, May, 2008)

Answer

Reporting of payments exceeding ₹ 20000 in cash: Such reporting is required to be done while conducting the tax audit u/s 44AB of the Income Tax Act, 1961 in Form 3CD. The tax auditor shall have to report under clause 21(d)(B) for the above as per the section 40A(3A) of the Income Tax Act, 1961 i.e. where an allowance has been made in the assessment for any year in respect of any liability incurred by the assessee for any expenditure and subsequently during any previous year the assessee makes payment in respect thereof, otherwise than by an account payee cheque drawn on a bank or account payee bank draft, the payment so made shall be deemed to be the profits and gains of business or profession and accordingly chargeable to income-tax as income of the subsequent year if the payments made to a person in a day, exceeds twenty thousand rupees.

In the instant case, the invoice for expenses has been booked in an earlier year. However, since payment for the same is made during the current year by cash exceeding ₹ 20000, the reporting thereof would be necessary in clause 21(d)(B) of Form 3CD. The sub-clause (d)(B) required furnishing of the amount inadmissible under section 40A(3A) read with rule 6DD along with computation.

The entire amount paid as above, is likely to be disallowed under section 40A(3A) of the Income Tax Act, 1961.

Question 16

Write short notes on Accounting ratios in Form 3 CD of Tax Audit. (4 Marks, November, 2007)

Answer

Accounting Ratios in Form 3CD of Tax Audit: Details regarding turnover, gross profit, etc., for the previous year and preceding previous year should be provided as follows:

Serial Number	Particulars	Previous year	Preceding Previous year
1.	Total turnover of the assessee		
2.	Gross profit/turnover		
3.	Net profit/turnover		
4.	Stock-in-trade/turnover		
5.	Material consumed/finished goods produced		

The details required to be furnished for principal items of goods traded or manufactured or services rendered. These ratios have to be calculated only for assessees who are engaged in manufacturing or trading activities. This clause is not applicable to assessees carrying on profession. Moreover, the ratios have to be given for the business as a whole and need not be given product wise.

Question 17

Write short notes on Method of accounting in Form No. 3CD of Tax Audit. (4 Marks, May, 2007)

Answer

Method of accounting in Form No. 3CD of Tax Audit: Clause 13 of Form No. 3CD of the tax audit requires to state method of accounting employed in the previous year. It also requires to state the change in method of accounting vis-à-vis the preceding year. If so, details of change and the effect on the profit or loss are to be stated. Also details of deviation thereof if any, from accounting standards prescribed under section 145 and the effect thereof on the profit or loss are stated.

Section 145 provide that method of accounting be either cash or mercantile. Hybrid system is not permitted.

Question 18

Labour charges paid on which tax is deducted at source at an inappropriate rate. As a tax auditor, how would you report? (4 Marks, May, 2006)

Answer

Reporting in Form 3CD: Section 40(a)(ia) of the Income-tax Act, 1961 specifies that amounts payable to a contractor or sub-contractor, being resident, for carrying out any work (including supply of labour for carrying out any work) on which tax is deductible under Chapter XVII-B and such tax has not been deducted or after deduction has not been paid on or before the due date specified in sub-section (1) of section 139, shall not be deducted in computing the income. Therefore, if tax is deducted at an inappropriate rate, the amount is disallowable under section 40(a)(ia) of the Income-tax Act. This fact needs to be reported in Clause 21(b)(ii) of Form 3CD where details of payment on which tax not deducted and details of payment on which tax has been deducted but not paid on or before the due date specified in sub- section (1) of section 139 needs to be reported. In case, the assessee submits that the

rate is proper, though in the auditor's view it is improper, the tax auditor should exercise his judgement and accordingly report in Clause 21(b)(ii) of Form 3CD.

Question 19

Enumerate some of the areas of concern in an audit of indirect taxes. (6 Marks, November, 2005)

Answer

Audit of Indirect Taxes: Some areas of concern in an audit of indirect taxes would be:

(i) Non availment or short / excess availment of control or expert incentives.

(ii) Goods imported duty free or payment at concessional rates without properly complying with conditions.

(iii) Valuation Issues – valuation not in line with customs rules.

(iv) Applicability of the relevant control excise exemptions.

(v) Valuation of goods not removed in normal course using valuation methods not in line with Central Excise Valuation Rules.

(vi) Ignoring Liability under Service Tax on services provided or availed.

(vii) Procedural non-compliance.

(viii) Passing on of duty suffered on imported goods and of locally manufactured goods in excess of actual.

(ix) Utilisation/Availability of credit of duty/ tax paid on inputs, capital goods of input services.

Question 20

As a tax auditor, which are the accounting ratios required to be mentioned in the report in case of manufacturing entities? Explain in detail any one of the above ratios and how does it help the tax auditor in his analytical review. (8 Marks, November, 2005)

Answer

Accounting Ratios in Form 3CD of Tax Audit: A tax auditor is required to provide details regarding turnover, gross profit, etc., for the previous year as well as for the preceding previous year in Form 3CD. The ratios which are to be calculated for manufacturing entities are:

- Gross profit / Turnover
- Net Profit / Turnover
- Stock-in-trade/Turnover
- Material consumed / Finished goods provided

Ratio analysis constitutes a substantive auditing procedure designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. Such assessment is necessary in organisation having large volumes of transactions and in the organisation following mechanised accounting system where it is not possible to check each and every transaction. It has the merit of bringing to focus the abnormal deviations and unexpected variations which the normal routine checking in auditing may fall to reveal. Ratios highlight only symptoms and that too as of a particular day and the auditor should study these symptoms properly, correlate them and reach definite conclusions or identify areas for further enquiries. The auditor should by relating sales with the net profit, various items of direct and indirect costs and gross profit gather information about the profitability and operating efficiency of an enterprise; variations in any of these ratios in a particular year should be inquired by the auditor. The fall in the gross profit ratio and profitability ratio should alert the auditor who should ask the management for the reasons thereof and which should be carefully examined by him. The auditor should by relating sales with the net profit, various items of direct and indirect costs and gross profit gather information about the profitability and operating efficiency of an enterprise; variations in any of these ratios in a particular year should be inquired by the auditor. The fall in the gross profit ratio and profitability ratio should alert the auditor who should ask the management for the reasons thereof and which should be carefully examined by him.

These ratios have to be given for the business as a whole and not product wise. While calculating these ratios, the tax auditor should assign a meaning to the terms used in the above ratios having due regard to the generally accepted accounting principles all the ratios mentioned in the clause are to be calculated in terms of value only.

The relationship of stock-in-trade to turnover over a period of time would reveal whether the entity has been accumulating stocks or there is a decline in the same. The auditor may obtain data for about 7-10 years, compute ratio of stock-in-trade/turnover and plot it on a graph paper over a period of time. This may give rise to several possibilities such as parallel horizontal lines, vertical rising line or a vertical falling line. A study of this relationship would reveal whether stocks are being accumulated or they are dwindling over a period. Such information would provide an input to tax auditor as to whether figures of either stock or turnover are being manipulated. Sometimes, while studying the relationship, it may show sudden decline or increase at a point of time would reflect that there is definitely something wrong with the figures of stock. Therefore, a close examination of such ratios helps the tax auditor to focus on major deviations and consequently reasons for the same.

16
Cost Audit

Question 1

For what purposes the Cost Auditor refers to financial records while conducting Cost Audit of an entity?

Answer

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, cost of inventory, employer costs, provision for depreciation, royalty and technical payment, abnormal cost, scrap, fuel etc. Annexure to the cost audit reports require 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 also contain a summary of all expenditure incurred by the company and the share in such expenditure attributable to the activities; 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 Schedule III to the Companies Act, 2013, quite a few matters which were to be mentioned in the Statement of Profit and Loss of the company are also to be covered in cost statements such as consumption of raw materials, purchases of stock-in-trade, sales of products/services, changes in inventories in respect of finished goods, work-in-progress, stock-in-trade 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 required 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 for conducting the cost audit.

Question 2

"Like every other audit, a systematic planning for cost audit is also necessary". Indicate the matters to be included in a Cost Audit Programme.

Answer

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 takes 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:

(a) Review of Cost accounting record: This will include:

(i) Method of costing in use - batch, process or unit.

(ii) Method of accounting for raw materials; stores and spares, wastages, spoilage defectives, etc.

(iii) System of recording wages, salaries, overtime and spares, wastages, etc.

(iv) Basis of allocation of overheads to cost centres and of absorption by products and apportionment of service department's expenses.

(v) Treatment of interest, recording of royalties, research and development expenses, etc.

(vi) Method of accounting of depreciation.

(vii) Method of inventory-taking and its valuation including inventory policies.

(viii) System of budgetary control.

(ix) System of internal auditing.

(b) Verification of cost statement and other data: This will mainly cover:

(i) Licensed, installed and utilised capacities.

(ii) Financial ratios.

(iii) Production data.

(iv) Cost of raw material consumed, wages and salaries, stores, power and fuel, overheads provision for depreciation etc.

(v) Sales realisation.

(vi) Abnormal non-recurring and special costs.

(vii) Cost statements.

(viii) 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.

Question 3

What are the advantages that accrue because of a Cost audit?

Answer

Cost Audit will be advantageous to the stockholders in the following manner:

To Management -

(i) Management will get reliable data for its day-to-day operations like price fixing, control, decision-making, etc.

(ii) A close and continuous check on all wastages will be kept through a proper system of reporting to management.

(iii) Inefficiencies in the working of the company will be brought to light to facilitate corrective action.

(iv) Management by exception becomes possible through allocation of responsibilities to individual managers.

(v) The system of budgetary control and standard costing will be greatly facilitated.

(vi) A reliable check on the valuation of closing inventory and work-in-progress can be established.

(vii) It helps in the detection of errors and fraud.

To Society -

(i) Cost audit is often introduced for the purpose of fixation of prices. The prices so fixed are based on the correct costing data and so the consumers are saved from exploitation.

(ii) Since price increase by some industries is not allowed without proper justification as to increase in cost of production, inflation through price hikes can be controlled and consumers can maintain their standard of living.

To Shareholder - Cost audit ensures that proper records are kept as to purchases and utilisation of materials and expenses incurred on wages, etc. It also makes sure that the valuation of closing inventories and work- in-progress is on a fair basis. Thus the shareholders are assured of a fair return on their investment.

To Government -

(i) Where the Government enters into a cost-plus contract, cost audit helps government to fix the price of the contract at a reasonable level.

(ii) Cost audit helps in the fixation of ceiling prices of essential commodities and thus undue profiteering is checked.

(iii) Cost audit enables the government to focus its attention on inefficient units.

(iv) Cost audit enables the government to decide in favour of giving protection to certain industries.

(v) Cost audit facilitates settlement of trade disputes brought to the government.

(vi) Cost audit and consequent management action can create a healthy competition among the various units in an industry. This imposes an automatic check on inflation.

Question 4

Write a short note on - True and Fair Cost of Production.

Answer

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 Companies (cost records and audit) Rules, 2014, prescribe the rules regarding the cost audit report and also prescribes the classes of companies required to include cost records in their books of account, applicability of cost audit, maintenance of records etc. 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/ etc. The provisions of sub-section (12) of section 143 of the Companies Act, 2013 and the relevant rules on duty to report on fraud shall apply mutatis mutandis to a cost auditor during performance of his functions under section 148 of the Act and these rules. 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.

Question 5

Write a short note on - Reconciliation of cost and financial accounts.

Answer

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 inventory, 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; 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 Schedule III to the Companies Act, 2013, quite a few matters which were to be mentioned in the Statement of Profit and Loss of the company are also to be covered in cost statements such as consumption of raw materials, purchases of stock-in-trade, sales of products/services, changes in inventories in respect of finished goods, work-in-progress, stock-in-trade etc.*** A correlation between consumption of raw materials as per cost records and financial records may through 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 required 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.

Question 6

What is the purpose served by Introduction of Cost audit?

Answer

According to the Institute of Cost and Management Accountants of England, cost audit represents the verification of cost accounts and a check on the adherence to cost accounting plan. Cost audit, therefore, comprises:

(i) verification of the cost accounting records such as the accuracy of the cost accounts, cost reports, cost statements, cost data and costing techniques and

(ii) examination of these records to ensure that they adhere to the cost accounting principles, plans, procedures and objectives.

The undernoted circumstances may warrant the introduction of cost audit:

(a) **Price fixation -** The need for fixation of retention prices in the case of materials of national importance, like steel, cement etc. may be useful in knowing the true cost of production.

(b) **Cost variation within the industry -** Where the cost of production varies significantly from unit to unit in the same industry, cost audit may be necessary to find the reasons for such differences.

(c) **Inefficient management -** Where a factory is run inefficiently and uneconomically, institution of cost audit may be necessary. It may be particularly useful for the Government before it takes over any unit.

(d) **Tax-assessment -** Where a duty or tax is levied on products based on cost of production, the levying authorities may ask for cost audit to determine the correct cost of production.

(e) **Trade disputes -** Cost audit may be useful in settling trade disputes about claim for higher wages, bonus, etc.

16
Cost Audit

Question 1

Write short notes on Cost records in respect of by products. *(4 Marks, November, 2013)*

Answer

Cost records in respect of By-products: Proper records should be maintained for each item of by-product, if any, showing the receipts, issues and balances both in quantity and value. The basis adopted for valuation of the by-products should be equitable and consistent. Records indicating the actual sales realisation of by-products should be maintained. If any expenses have been incurred in further process of by-products, such expenses should also be separately stated. The treatment of realization of By-products in the determination of cost of main product should also be mentioned.

Question 2

Write short notes on Cost Statements. *(4 Marks, May, 2012)*

Answer

Cost Statements - Cost Statements or cost sheets are required to be prepared as part of the cost records in respect of each product. The forms of cost sheets have been prescribed in the Annexure to the respective Rules. The forms have been so devised arranged that they progressively build up the cost of production of the concerned products. The nature, purpose and contents of the cost sheet depend upon the nature of the products, production method, process involved, cost centres and the elements that make up the cost.

Question 3

Write short notes on Reconciliation of Cost and Financial Accounts.(5 Marks, November, 2010)

Answer

Reconciliation of Cost and Financial Accounts: The cost records should be reconciled (preferably periodically) with the financial books of account so as to ensure accuracy. Variations if any, should be clearly indicated and explained. The period for which such reconciliation be effected should not exceed the period of the financial year of the company. The reconciliation should be done in such a manner that profitability of the product under reference can be correctly adjudged and reconciled with the overall profits of the company. A statement showing the total expenses incurred by the company, including expenses excluded from the costing records and expenses on products not covered by the relevant Cost Records and Audit Rules, should be prepared and the share of the product covered by the Rules in such expenses should be indicated. Also the sale realisation of the products should be shown separately for products covered by the Rules and products not so covered and the margin representing the difference between respective sales realisation and the corresponding total cost should be determined. This statement in turn should be reconciled with the financial profit and loss account for the period. It may be mentioned that where a system of integrated cost and financial accounting is in operation, this reconciliation will be facilitated to a large extent. It should be ensured that the specific information required to be contained in both the costing and financial statements is not different. If at all any difference arises, the same should be properly reconciled and kept on record for reference.

Question 4

What is the purpose served by Introduction of Cost audit? *(4 Marks, May, 2010)*

Answer

Introduction of Cost audit: According to the Institute of Cost and Management Accountants of England, cost audit represents the verification of cost accounts and a check on the adherence to cost accounting plan. Cost audit, therefore, comprises:

(i) verification of the cost accounting records such as the accuracy of the cost accounts, cost reports, cost statements, cost data and costing techniques and

(ii) examination of these records to ensure that they adhere to the cost accounting principles, plans, procedures and objectives.

The undernoted circumstances may warrant the introduction of cost audit:

(i) **Price fixation** – The need for fixation of retention prices in the case of materials of national importance, like steel, cement etc., may be useful in knowing the true cost of production.

(ii) **Cost variation within the industry** -where the cost of production varies significantly from unit to unit in the same industry, cost audit may be necessary to find the reasons for such differences.

(iii) **Inefficient management** – Where a factory is run inefficiently and uneconomically, institution of cost audit may be necessary. It may be particularly useful for the Government before it takes over any unit.

(iv) **Tax assessment** – Where a duty or tax is levied on products based on cost of production, the levying authorities may ask for cost audit to determine the correct cost of production.

(v) **Trade disputes** – Cost audit may be useful in settling trade disputes about claim for higher wages, bonus, etc.

Question 5

What are the advantages that accrue to the stockholders of a company because of a Cost audit? *(8 Marks, May, 2007)*

Answer

Advantages of Cost Audit: Cost Audit will be advantageous to the stockholders in the following manner:

(A) To Management:

(i) Management will get reliable data for its day-to-day operations like price fixing, control, decision-making, etc.

(ii) A close and continuous check on all wastages will be kept through a proper system of reporting to management.

(iii) Inefficiencies in the working of the company will be brought to light to facilitate corrective action.

(iv) Management by exception becomes possible through allocation of responsibilities to individual managers.

(v) The system of budgetary control and standard costing will be greatly facilitated.

(vi) A reliable check on the valuation of closing stock and work-in-progress can be established.

(vii) It helps in the detection of errors and fraud.

(B) To Society:

(i) Cost Audit is often introduced for the purpose of price fixation. Customers are saved from exploitation through proper costing of products and services.

(ii) Since price increase by some industries is not allowed without proper justification as to increase in cost of production, inflation through price hikes can be controlled and consumers can maintain their standard of living.

(C) To Shareholders: Cost Audit ensures that proper records are kept as to purchases and utilization of materials and expenses incurred on wages etc. It also makes sure that the valuation of closing stock and work-in-progress is on a fair basis. The shareholders are assured about the calculation of the profitability and thus return on their investments.

(D) To Government:

(i) Where the Government enters into a cost-plus contract, cost audit helps government to fix the price of the contract at a reasonable level.

(ii) Cost audit helps in the fixation of selling prices of essential commodities and thus undue profiteering is checked.

(iii) Cost audit enables the government to focus its attention on inefficient units.

(iv) Cost audit enables the government to decide in favour of giving protection to certain industries.

(v) Cost audit facilitates settlement of trade disputes brought to the government.

(vi) Cost audit and consequent management action can create a healthy competition among the various units in an industry. This imposes an automatic check on inflation.

Question 6

"Like every other audit, a systematic planning for cost audit is also necessary". Indicate the matters to be included in a Cost Audit Programme. (10 Marks, November, 2005)

Answer

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 dome are adequately takes 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:

(A) Review of Cost accounting record: This will include:

(i) Method of costing in use - batch, process or unit.

(ii) Method of accounting for raw materials; stores and spares, wastages, spoilage defectives, etc.

(iii) System of recording wages, salaries, overtime and spares, wastages, etc.

(iv) Basis of allocation of overheads to cost centres and of absorption by products and apportionment of service department's expenses.

(v) Treatment of interest, recording of royalties, research and development expenses, etc.

(vi) Method of accounting of depreciation.

(vii) Method of stock-taking and its valuation including inventory policies.

(viii) System of budgetary control.

(ix) System of internal auditing.

(B) Verification of cost statement and other data: This will mainly cover:

(i) Licensed, installed and utilised capacities.

(ii) Financial ratios.

(iii) Production data.

(iv) Cost of raw material consumed, wages and salaries, stores, power and fuel, overheads provision for depreciation etc.

(v) Sales realisation.

(vi) Abnormal non-recurring and special costs.

(vii) Cost statements.

(viii) 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.

Question 7

Write short notes on Advantages of Cost Audit to Government. (4 Marks, November, 2004)

Answer

Advantages of Cost Audit to Government: Cost auditor's approach is to ensure that the cost accounting plan is in consonance with the objectives set by the organisation and the system of accounting is geared towards the attainment of the objectives. A cost accounting system designed to exercise control over cost may be different from the one if the objective is to fix price. Accordingly, over a period of time particularly in view of administered pricing system the cost accounting becomes quite important. Some of the specific advantages which can be reaped by the Government are:

(i) Where the Government enters into a cost-plus contract, cost audit helps government to fix the price of the contract at a reasonable level.

(ii) Cost audit helps in the fixation of selling prices of essential commodities and thus undue profiteering is checked.

(iii) Cost audit enables the government to focus its attention on inefficient units.

(iv) Cost audit enables the government to decide in favour of giving protection to certain industries.

(v) Cost audit facilitates settlement of trade disputes brought to the government.

(vi) Cost audit and consequent management action can create a healthy competition among the various units in an industry. This imposes an automatic check on inflation.

17

Special Audit Assignments

Question 1

What are the key functions of an Energy Auditor?

Answer

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.

Question 2

Enumerate the main areas to be covered by the auditor in the case of environment audit of an industrial unit.

Answer

Main areas to be covered in the case of environment audit of an industrial unit

(i) Layout and Design – The layout to be sketched in the style which will allow adequate provisions for installing pollution control devices, as well as provision for up gradation of pollution control measures and the meeting of the requirements of the regulations framed by the Government. In the course of the audit, the area which requires attention but not attended to by the industry to be pinpointed as well as the future requirements of the environmental measures required in commensuration with the proposed future course of working plan are to be identified.

(ii) Management of Resources – Management resources includes air, water, land, energy, raw materials and human resources besides others. The use of all resources is interlinked and the best uses in a synchronised manner results the best output and minimum waste. The waste of resources to the minimum possible extent is good for the health of the industry as well as the environment.

(iii) Pollution Control System – An effective system of pollution control should be in existence. One aspect should be whether all required pollution control measures are in vogue or not next aspect should be whether the same is effective or not, further it is to investigate, whether more measures are required, keeping ill view the type of industry and it's nature of working with respect to it's grade of polluting the environment.

(iv) Emergent Safety Arrangement – The chemical, gas, etc., industries which are prone to sudden requirement of safety arrangements, must remain alert all the while. The emergency plans are to be reviewed periodically; sufficient staff along with other required safety amenities should be kept ready. The staff, remained so engaged, must possess the required awareness and alertness to meet the contingency. The degree of awareness, however, can be upgraded with proper training provisions.

(v) Medical & Healthcare Facilities – The medical services should be maintained. The health of the workers should be a big consideration for the management.

(vi) Industrial Hygiene – Proper system should be in vogue to eliminate industrial unhygienic state.

(vii) Occupational Health – The requirement for safeguarding against occupational health hazards should be available for all the workers. As the occupational health hazards varies from industry to industry due to the difference in the nature of working atmosphere and the pollutants present in it, the concerned industry must pay proper weightage to those diseases which are prone to that particular type of industry.

(viii) Information Assimilation and Reporting System – The information system should be strengthened to generate and its reporting system should be proper, keeping in view, the authorities, responsibilities and subsequent delegations. A report of compliance of all

statutory environmental laws along with other preventive and precautionary measures should be put to Board at regular intervals.

(ix) EIA Methodology – The Environmental Impact Assessment (EIA) is usually are pre-requisites to start an industry. This is done considering the known spheres of activities on the existing environmental conditions. But the predictions necessarily deviate from the actual happenings when the industry starts working. To accommodate the deviation in the system is also to be incorporated in the EIA report, if it is noticed that the degradation to the environment caused on the establishment and running of the industry is much higher than what was predicted, the mitigatory measures suggested must also be furthered.

(x) Compliance to the Regulatory Mechanism – As the persons who are directly working with the system, may be unaware of the latest developments and requirements for the compliance of stipulations and standards prescribed by the various regulatory authorities, they should be trained and instructed on regular basis, to avoid making the Board/owner vulnerable to prosecution and penalty.

(xi) Concern for the Society – The industry very often transforms the agrarian environment into an industrial environment. The people so displaced by industrialisation feel alienated and develop a feeling of facing the gaseous, dustful, clumsy state of surroundings. The audit should look into this aspect how the industry is making a balance between its own development and the society's concern.

Question 3

Write short note on Rolling Settlements.

Answer

Rolling Settlements: A rolling settlement is one in which trades outstanding at the end of the day have to be settled (payments made for purchases or deliveries in the case of sale of securities) within "X" business days from the transaction date. Thus, in a T+2 rolling settlement, a transaction entered into on Monday for instance, will be settled on Wednesday when the pay-in or pay-out takes place.

In the rolling settlement, trades on each single day are settled separately from the trades done earlier or subsequent trade days. The netting of trades is done only for the day and not for multiple days.

SEBI has gradually mandated most of the scrips to be settled exclusively on Rolling Settlement basis (T+2). The transactions in the Compulsory Rolling Settlement (CRS) are settled on T+2 basis, i.e., both pay- in and pay- out of monies and securities for transactions in scrips on transaction day (T day) would take place on the day after immediately following day.

However, transactions in 'Z' group securities are settled only on trade to trade basis on T+2, i.e., the facility of netting up of buy and sell transactions of the same day, as available in other securities, is not available with securities falling under 'Z' group. In other words, if an investor buys and sells X no. of shares on the same day, then he shall first have to actually deliver and then receive the securities on the settlement day.

Value at Risk (VaR) based margining approach has been adopted for transactions done in CRS scrips with effect from July 2, 2001. In the VaR system of margining, historical volatilities of scrips and overall market volatility is considered to arrive at a VaR margin percentage for scrip. Further, the mark-to-market differences are collected on a daily basis and the broker members are required to maintain a capital level, as prescribed by the Exchange, adequate to support their exposure at all times.

In case, a member fails to deliver the shares sold in rolling settlement, the Exchange conducts an auction session on T+2, to meet the shortfall created by non-delivery of shares. In this auction session, offers are invited from the other members to deliver the shares sold by originally selling member, since delivery has to be made to the buying member. In case no shares are received in auction, the sale transaction is closed-out at a close-out price, determined by higher of the following:

- Highest price recorded in the scrip from the settlement in which the transaction took place upto a day prior to the auction.

  OR

- 20% above the closing price on a day prior to the auction.

In this case, the auction price/close-out and difference between sale price, if positive is payable by the seller who failed to deliver the scrips. In case, auction /close out price is less than sale price, the difference is not given to the seller but is credited to Investor Protection Fund.

Question 4

State the items contained in the SEBI's check list for auditors in respect of contract notes issued by a Stock Broker.

Answer

SEBI's check list for auditors in respect of contract notes issued by a Stock Broker

(i) Members should issue Contract Notes to his clients for all trades executed by him on their behalf.

(ii) The member should stamp his order sheets/records and the order time should be reflected in the Contract Note along with the time of execution of order.

(iii) The Contract Notes should bear SEBI Registration number of the member. It should be pre-printed with serial number and issued within 24 hours of trade execution. Appropriate stamps should be affixed on the contract Note. Duplicate copies of the contract note should be maintained.

(iv) The Contract Note should be signed by the member or his constituted attorney.

(v) Contract note issued to the clients should show the brokerage separately.

(vi) In case the broker acts as a principal, the Contract Note should be in Form B.

(vii) Consent of the client should be taken for any trade done by the broker while acting as a principal.

(viii) Brokerage should be within the limits prescribed by the exchange.

Question 5

Write short notes on the following –

(a) Contract notes.

(b) Sauda Book.

Answer

(a) 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.

(b) Sauda Book: All members are required to maintain a 'Sauda Book', which contains details of all deals transacted by them on a day to day basis. This is a basic record, which each member is required to maintain regularly on day-to-day basis. It contains the details regarding the name of the code of the client on whose behalf the deals have been done, rate and quantity of bought or sold. These details are maintained date wise. This register contains all the transactions, which may be of any of the kind mentioned below:

(i) member's own business on the Exchange;

(ii) member's business on the Exchange on behalf of clients;

(iii) member's business with the clients on principal-to-principal basis;

(iv) member's business with the members of other Stock Exchanges;

(v) member's business on behalf of his clients with the members of other Stock Exchanges;

(vi) Spot transactions, etc.

Question 6

Write a short note on the following-

(a) Margins (Under Stock Exchange Trading Regulations).

(b) Types of market under NEAT (National Exchange Automated Trading).

Answer

(a) Margins: Margin refers to deposit made by members with the stock exchange authorities. There can be wide fluctuations at the time of settlement in the prices of securities since the closing rate of the earlier settlement. In order to restrict excessive speculation and also to safeguard the interests of the investors, members are required to keep certain deposits with the stock exchange authorities. These deposits are termed 'margins'. The members are required to collect the margin from their clients, wherever applicable, and deposit the amount collected with the Clearing House. Margin is intended to protect the members by providing them with funds to cover anticipated fluctuations in prices of securities, particularly, if the client delays in paying the amount or is unable to meet his commitments. Margins also help prevent excessive speculation as clients would be required to invest some funds and not indulge in speculation without adequate resources. A member is required to pay or deposit different margins such as Gross Exposure Margin, Mark to Market (MTM) Margin, Volatility Margin (VM), Additional Volatility Margin (AVM), Special Margin and Adhoc Margin. The members are required to compute margin payable for all securities traded by them and make the margin payments

on the due date to the Stock Exchange authorities. Different types of margins are payable at stipulated time, as decided by the Exchange or Clearing House of the Exchange.

(b) Type of markets under NEAT: The NEAT system has four main types of market. They are:

Normal Market: All orders which are of regular lot size or multiples thereof are traded in the normal market. For shares which are traded in the compulsory dematerialised mode the market lot of these shares is one. Normal market consists of various book types wherein orders are segregated as regular lot orders, special term orders, negotiated trade orders and stop loss orders, depending on their order attributes.

Odd Lot Market: An order is called an odd lot order if the order size is less than regular lot size; such orders are traded in the odd-lot market. These orders do not have any special terms or attributes attached to them. In an odd-lot market, both the price and quantity of both the orders (buy and sell) should exactly match for the trade to take place.

Spot Market: Spot orders are similar to the normal market orders except that spot orders have different settlement periods vis-à-vis normal market. These orders do not have any special terms or attributes attached to them.

Auction Market: In the auction market, auctions are initiated by the Exchange on behalf of trading members for completing the settlement process.

Question 7

Write a short note on - Circuit Filters/Circuit Breakers (as specified by SEBI).

Answer

Circuit Filters: Circuit Breakers or circuit filters are the price bonds that set the upper and lower limit within which a stock can fluctuate on any particular day. A price band for a day is a function of previous trading day's closing. SEBI has directed the exchanges to apply circuit filters on scrips traded in Rolling Settlement if their price fluctuates more than 20% of the closing price of scrips on the previous day in any direction. However, feeling the threat of high settlement default in scrips forming part of sensex or in which derivatives and futures are available, because of these filters, SEBI has restricted the fluctuation to 10% instead of 20%.

Price bands restrict extreme price movements and thereby resist price manipulation. These protect investors from extreme fluctuations in a panic market created by rumours and short term fears.

Question 8

Write short notes on the following-

(a) Environmental audit.

(b) Probable format of environmental statement.

Answer

(a) Environmental Audit: Environmental reporting deals with the disclosure by an entity of environmentally related data, regarding environmental risks, environmental impacts, policies, strategies, targets, costs, liabilities or environmental performance to those who have an interest in such information as an aid to enabling/enriching their relationship with the reporting entity via either the annual report; a stand-alone corporate environmental performance report; or some other medium (e.g. staff newsletter, video, CD ROM, internet site). The reports that are generated after such audits can be either compliance-based reporting or impact-based performance reporting.

Environmental audit deals with verification of information contained in such reports with a view to expressing an opinion thereon. Environmental audit can be performed by external agencies or internal experts (including internal auditors). In practice, environmental audit is not done by a single agency but by various agencies who are experts in the field. Since the subject matter of environmental audit involves multi-disciplinary knowledge and skill, it is preferable to form a team of persons drawn from different disciplines who may assist the chartered accountant in performing the task in an effective manner, generally environmental audits are not required by any statute but are sometimes done at the request of the management to address issues like compliance with environmental laws and regulations, etc.

(b) Probable format of "Environmental Statement": The following are the main aspects which may be covered in the probable format of "Environmental Statement"-

(i) Name and address of the owner/occupier of the industry, operation or process.

(ii) Date of last environmental audit report submitted.

(iii) Consumption of water and other raw materials as input during current and previous year.

(iv) Pollution generated in air and water along with the output and the types of pollutants and the deviation from standard.

(v) Generation of hazardous waste (in line with the Hazardous Waste Management and Handling Rules, 1989) in current year and previous year from processes or from pollution control facility.

(vi) Quantity of sold waste generated during current year and previous year from process/es from pollution control facility and from recycling or reutilisation of waste, etc.

(vii) The disposal practice for different type of waste.

(viii) The practice sorted for conservation of natural resources.

(ix) The additional investment proposal for environmental protection including abatement of pollution.

Question 9

Write a short note on Contents of Audit report of Mutual Fund.

Answer

Audit report of mutual fund: It comprises the following-

(i) the auditor has obtained all information explanations which, to the best of his knowledge and belief, were necessary for the purpose of the audit;

(ii) the balance sheet and the revenue account give a fair and true view of the scheme, state of affairs and surplus or deficit in the Fund for the accounting period to which the Balance Sheet or, as the case may be, the Revenue Account relates;

(iii) the statement of account has been prepared in accordance with accounting policies and standards as specified in the Ninth Schedule.

Question 10

Write short notes on the purpose of appointing Inspecting officer of a Depository.

Answer

SEBI appoints inspecting officers to investigate or inspect the affairs of a depository for any of the following purposes:

(i) To ensures that the books of accounts are maintained in the names specified in the regulations.

(ii) To look into the complaints received from depositors' participant, beneficial owners or other persons.

(iii) To ascertain whether the provisions of the Act, bye-laws agreements and these regulations are being complied.

(iv) To ascertain whether the systems, procedures and safeguards are being followed in the interests and to secure the market.

(v) To ensure that the affairs are being conducted in the interest of the Investors / Securities markets.

Question 11

Write short note on Volatility margin.

Answer

Volatility Margin: Volatility margin is imposed to curb excessive volatility in the market and to act as a deterrent to building up of excessive outstanding positions. Price variations on account of calls, bonuses, rights, mergers, amalgamations and schemes of arrangements are adjusted for determining volatile securities and adjustments in prices is made for the purpose of computation of volatility, when securities are traded ex-benefits. Securities that attract volatility margin and the applicable margin rates are announced on the last day of the trading cycle and are applicable from the first day of the succeeding trading cycle. The volatility margin is levied on the net outstanding positions of the member, in each security, based on the respective margin rates.

Question 12

How is an auditor concerned under the guidelines issued by Securities and Exchange Board of India relating to the following matters, while certifying financial information included in offer documents?

(i) Transactions with companies in promoter group

(ii) Bifurcated turnover

(iii) Return on net worth

(iv) Price earning ratio

Answer

As per the SEBI Guidelines, an auditor is required to report on the financial information to be included in the offer documents. The above four items form part of such information.

(i) Transactions with companies in promoter group: Disclosure is required to be made in the offer document in respect of the following:

(a) Sales or purchase between companies in the promoter group when such sales or purchases exceed in value in the aggregate 10% of the total sales or purchases of the issuer; and

(b) Material items of income or expenditure arising out of transactions in the promoter group. (Sub Para 3.5 of Para 10 of Chapter VI).

The aforesaid information is required to be given by the auditor of the issuer company in his report for inclusion in the offer documents.

(ii) Bifurcated Turnover: The turnover disclosed in the profit and loss statement shall be bifurcated into:

(a) turnover of products manufactured by the company;

(b) turnover of the products traded in by the company; and

(c) details of products not normally dealt in by the company but included in (b) above are required to be mentioned separately. (Clause c of Sub Para 2.7 of Para 10 of Chapter VI).

(iii) Return on Net Worth: Clause (f) of Sub Para 2.7 of Para 10 of Chapter VI requires that the offer document to include certain accounting ratios for each of the accounting periods for which information is given. Return on net worth is one of such accounting ratios. This ratio is computed by using the following formula:

$$\frac{\text{Net Profit before extraordinary items but after adjusted tax}}{\text{Net worth excluding revaluation reserve as at the end of the year}} \times 100$$

In the above formula the adjusted tax means the provision for taxation for the period after adjusting tax attributable to extraordinary items. The above forms part of the other financial information required to be included by the management and which should be reported upon the company's auditor by way of separate report to management. The management is required to get this information audited by the company's auditor and obtain an audit report in respect thereof.

(iv) Price Earning Ratio: Clause (a) of Sub Para 4.11 of Para 8 of Chapter VI under the heading 'Basis for Issue Price' requires disclosure of P/E pre-issue and comparison thereof with industry P/E where available (giving the source from which industry P/E has been taken). The pre-issue price / earnings ratio should be calculated by using the following formula:

$$\frac{\text{Issue price per share}}{\text{Earning per share}} \times 100$$

Earning per share is to be disclosed as per Part A-I of clarification XIV is the EPS after taking into account all outstanding conversions and options i.e. diluted earning per share. The auditor should satisfy that the calculations have been made accordingly.

Question 13

Write short notes on the Mark to Market margins.

Answer

Mark to Market Margin (MTM) : MTM margin is the notional loss, which a stock member or his client would incur, if the net cumulative outstanding positions in all securities were closed out at the closing price of the relevant trading day, which is different from the price at which the transaction had been entered into. For each security, this is worked out by multiplying the difference between the closing price and the price at which the trade was executed by the cumulative buy and sell open position (for buy position the close price being lower than actual trade price and for sell position the close price being higher than actual trade price). The aggregate amount computed across all securities is MTM margin payable by a member. The mark-to-market margin is payable with reference to net position at client's level.

Question 14

Write short note on-Volatility Margin, its computation and its application.

Answer

Volatility Margin: Volatility margin is imposed to curb excessive volatility in the market and to act as a deterrent to building up of excessive outstanding positions.

Computation: Price variations on account of calls, bonuses, rights, mergers, amalgamations and schemes of arrangements are adjusted for determining volatile securities and adjustments in prices is made for the purpose of computation of volatility, when securities are traded ex-benefits.

Application: Securities that attract volatility margin and the applicable margin rates are announced on the last day of the trading cycle and are applicable from the first day of the succeeding trading cycle. The volatility margin is levied on the net outstanding positions of the member, in each security, based on the respective margin rates.

Question 15

Write short notes on Environment Impact Assessment.

Answer

Environment Impact Assessment: The Environmental Impact Assessment (EIA) is usually pre-requisites to start an industry. This is done considering the known spheres of activities on the existing environmental conditions. But the predictions necessarily deviate from the actual happenings when the industry starts working. To accommodate the deviation in the system is also to be incorporated in the EIA report, if it is noticed that the degradation to the environment caused on the establishment and running of the industry is much higher than what was predicted, the mitigatory measures suggested must also be furthered.

Question 16

Write short notes on the matters to be reported in respect of inventory in the case of a special audit of a non-corporate borrower of a Bank.

Answer

Matter to be reported in respect of inventory in the case of a special audit of a non-corporate borrower of a Bank: A lending bank may, in special cases, require the non-corporate entity to obtain a special report from the auditor. Such a report can be called by a lending bank if it finds that it is necessary to have more information about the working of the entity. In such a case the report will have to be given by the auditor on a quarterly basis. The special audit report which is to be given on a quarterly basis in the specified form is in addition to the normal audit report which is to be given by the auditor on a yearly basis.

(i) In the quarterly special audit report, the auditor will have to give information relating to the operating data for each quarter. This information will have to be classified in the actual production; actual production as a percentage of rated capacity, sales, cost of goods sold/cost of production, gross margin, interest on bank borrowing etc. Further, the age-wise classification of raw materials and finished goods is to be given.

(ii) For this purpose, age-wise classification is to be made in the following manner in respect of raw materials and finished goods separately:

- ***(a) Inventory for more than 1 year***
- ***(b) Between 6 months and 1 year***
- ***(c) Between 3 months and 6 months***
- ***(d) Below 3 months.***

Similar information about the work-in-progress (i.e. the number of days of production which remains in progress) should also be given.

The basis of the valuation of raw material and finished goods should be given. For this purpose, the following information is to be given:

(a) The manner of determination of cost (i.e. components of cost).

(b) The method of valuing stock i.e. FIFO, weighted average cost.

17

Special Audit Assignments

Question 1

Write short notes on Environment Impact Assessment. *(4 Marks, November, 2013)*

Answer

Environment Impact Assessment: The Environmental Impact Assessment (EIA) is usually pre-requisites to start an industry. This is done considering the known spheres of activities on the existing environmental conditions. But the predictions necessarily deviate from the actual happenings when the industry starts working. To accommodate the deviation in the system is also to be incorporated in the EIA report, if it is noticed that the degradation to the environment caused on the establishment and running of the industry is much higher than what was predicted, the mitigatory measures suggested must also be furthered.

Question 2

Write short notes on Volatility Margin, its computation and its application.(4 Marks, May, 2013)

Answer

Volatility Margin: Volatility margin is imposed to curb excessive volatility in the market and to act as a deterrent to building up of excessive outstanding positions.

Computation: Price variations on account of calls, bonuses, rights, mergers, amalgamations and schemes of arrangements are adjusted for determining volatile securities and adjustments in prices is made for the purpose of computation of volatility, when securities are traded ex-benefits.

Application: Securities that attract volatility margin and the applicable margin rates are announced on the last day of the trading cycle and are applicable from the first day of the succeeding trading cycle. The volatility margin is levied on the net outstanding positions of the member, in each security, based on the respective margin rates.

Question 3

Write short notes on the following:

(a) Circuit filters/Circuit breakers. *(4 Marks, November, 2012) (5 Marks, November, 2010) (4 Marks, November, 2008) (4 Marks, November, 2007)*

(b) Environmental Audit. *(4 Marks, November, 2012)*

Answer

(a) Circuit Filters/Circuit Breakers:

(i) This is the price band that set the upper and lower limit within which a stock can fluctuate on any particular day.

(ii) A price band for a day is a function of the previous day's closing price.

(iii) According to SEBI directions circuit filter is applied on scrips traded in rolling settlement, if their price fluctuate more than 20% of the closing price of scrip on the previous day in any direction.

(iv) However, feeling the threat of high settlement default in scrips forming part of sensex or in which derivatives and futures are available, because of these filters, SEBI has restricted the fluctuation to 10% instead of 20%.

(v) Thus circuit filters restrict extreme price movement and resist price manipulation.

(vi) This also protects investor from extreme fluctuations.

(b) Environmental Audit: Environmental reporting deals with the disclosure by an entity of environmentally related data, regarding environmental risks, environmental impacts, policies, strategies, targets, costs, liabilities or environmental performance to those who have an interest in such information as an aid to enabling/enriching their relationship with the reporting entity via either the annual report; a stand-alone corporate environmental performance report; or some other medium (e.g. staff newsletter, video, CD ROM, internet site). The reports that are generated after such audits can be either compliance-based reporting or impact-based performance reporting.

Environmental audit deals with verification of information contained in such reports with a view to expressing an opinion thereon. Environmental audit can be performed by external agencies or internal experts (including internal auditors). In practice, environmental audit is not done by a single agency but by various agencies who are experts in the field. Since the subject matter of environmental audit involves multi-disciplinary knowledge and skill, it is preferable to form a team of persons drawn from different disciplines who may assist the chartered accountant in performing the task in an effective manner, generally environmental audits are not required by any statute but are sometimes done at the request of the management to address issues like compliance with environmental laws and regulations, etc.

Question 4

Write short notes on the following:

(a) Mark to Market Margin. *(4 Marks, May, 2012) (4 Marks, May, 2010)*

(b) Matter to be reported in respect of inventory in the case of a special audit of a non-corporate borrower of a Bank. *(4 Marks, May, 2012)*

Answer

(a) Mark to Market Margin (MTM): MTM margin is the notional loss, which a stock member or his client would incur, if the net cumulative outstanding positions in all securities were closed out at the closing price of the relevant trading day, which is different from the price at which the transaction had been entered into. For each security, this is worked out by multiplying the difference between the closing price and the price at which the trade was executed by the cumulative buy and sell open position (for buy position the close price being lower than actual trade price and for sell position the close price being higher than actual trade price). The aggregate amount computed across all securities is MTM margin payable by a member. The mark-to-market margin is payable with reference to net position at client's level.

(b) Matter to be reported in respect of inventory in the case of a special audit of a non-corporate borrower of a Bank: A lending bank may, in special cases, require the non-corporate entity to obtain a special report from the auditor. Such a report can be called by a lending bank if it finds that it is necessary to have more information about the working of the entity. In such a case the report will have to be given by the auditor on a quarterly basis. The special audit report which is to be given on a quarterly basis in the specified form is in addition to the normal audit report which is to be given by the auditor on a yearly basis.

(i) In the quarterly special audit report, the auditor will have to give information relating to the operating data for each quarter. This information will have to be classified in the actual production; actual production as a percentage of rated capacity, sales, cost of goods sold/cost of production, gross margin, interest on bank borrowing etc. Further, the age-wise classification of raw materials and finished goods is to be given.

(ii) For this purpose, age-wise classification is to be made in the following manner in respect of raw materials and finished goods separately:

(a) Inventory for more than 1 year

(b) Between 6 months and 1 year

(c) Between 3 months and 6 months

(d) Below 3 months.

Similar information about the work-in-progress (i.e. the number of days of production which remains in progress) should also be given.

The basis of the valuation of raw material and finished goods should be given. For this purpose, the following information is to be given:

(a) The manner of determination of cost (i.e. components of cost).

(b) The method of valuing stock i.e. FIFO, weighted average cost.

Question 5

State the functions of Energy Auditor. *(5 Marks, November, 2011)*

Or

Enumerate some of the key functions of the Energy Auditor. *(8 Marks, May, 2007)*

Or

What are the key functions of an Energy Auditor? *(8 Marks, May, 2004)*

Answer

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.

Question 6

Write short notes on Contract notes in case of audit of member of Stock Exchange.

(4 Marks, November, 2011)

Or

Write short notes on Contract Notes (Under Stock Exchange Trading Regulations).

(4 Marks, November, 2005)

Answer

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.

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.

Question 7

Write short notes on Volatility margin. *(4 Marks, May, 2011)*

Answer

Volatility Margin: Volatility margin is imposed to curb excessive volatility in the market and to act as a deterrent to building up of excessive outstanding positions. Price variations on account of calls, bonuses, rights, mergers, amalgamations and schemes of arrangements are adjusted for determining volatile securities and adjustments in prices is made for the purpose of computation of volatility, when securities are traded ex-benefits. Securities that attract volatility margin and the applicable margin rates are announced on the last day of the trading cycle and are applicable from the first day of the succeeding trading cycle. The volatility margin is levied on the net outstanding positions of the member, in each security, based on the respective margin rates.

Question 8

Write short notes on Probable format of Environmental Statement. *(4 Marks, June, 2009)*

Answer

Probable format of "Environmental Statement": The following are the main aspects which may be covered in the probable format of "Environmental Statement"-

(i) Name and address of owner/occupier of the industry, operation or process.

(ii) Date of last environmental audit report submitted.

(iii) Consumption of water and other raw materials as input during current and previous year.

(iv) Pollution generated in air and water with output and types of pollutants and deviation from standard.

(v) Generation of hazardous waste in current year and previous year from processes or from pollution control facility.

(vi) Quantity of sold waste generated during current year and previous year from process/es from pollution control facility and from recycling or reutilization of waste, etc.

(vii) The disposal practice for different type waste.

(viii) The practice of conservation of natural resources.

(ix) The additional investment proposal for environmental protection including abatement of pollution.

Question 9

Write short notes on Purpose of appointing Inspecting officer of a Depository.

(4 Marks, November, 2008)

Answer

Purpose of appointing Inspecting officer of a Depository: The SEBI may appoint one or more persons as inspecting officer to undertake the inspection of the books of account,

records, documents and infrastructure, systems and procedures or to investigate the affairs of a mutual fund, the trustees and asset Management Company for any of the following purposes, namely-

(1) To ensure that the books of accounts are maintained in the names specified in the regulations;

(2) To look into the complaints received from depositors' participant, beneficial owners or other persons;

(3) To ascertain whether the provisions of the Act, bye-laws agreements and these regulations are being complied;

(4) To ascertain whether the systems, procedures and safeguards are being followed in the interests and to secure the market;

(5) To ensure that the affairs are being conducted in the interest of the Investors / Securities markets.

Question 10

In the context of Audit of members of Stock Exchanges, explain what is Rolling Settlement?

(5 Marks, May, 2008)

Or

Write short explanatory notes on Rolling Settlement. *(4 Marks, May, 2004)*

Answer

Rolling settlement: A rolling settlement is one in which trades outstanding at the end of the day have to be settled (payments made for purchases or deliveries in the case of sale of securities) within 'X' business days from the transaction date.

In the rolling settlement, trades on each single day are settled separately from the trades done earlier or subsequent trade days. The netting of trades is done only for the day and not for multiple days.

SEBI has gradually mandated most of the scrips to be settled exclusively on Rolling Settlement basis [t +2]. Thus, in a T+2 rolling settlement, a transaction entered into on Monday, for instance, will be settled on Wednesday when the pay-in or pay-out takes place. The transaction in the Compulsory Rolling Settlement (CRS) are settled on T+2 basis i.e. both pay in and pay out of monies and securities for transactions in scrips on transaction day (T-Day) would take place on the day after immediately following day.

However, transactions in 'Z' group securities are settled only on trade to trade basis on T+2, i.e. the facility of netting up of buy and sell transactions of the same day, as available in other securities, is not available with securities falling under 'Z' group. In other words, if the investor buys and sells X number of shares on the same day, then he shall first have to actually deliver and then receive the securities on the settlement day.

Value at Risk (VaR) based margining approach has been adopted for transactions done in CRS scrips w.e.f. July 2, 2001. In the VaR system of margining, historical volatilities of scrips and overall market volatility is considered to arrive at a VaR margin percentage for a scrip. Further the mark-to-market difference are collected on a daily basis and the broker members are required to maintain a capital level, as prescribed by the exchange, adequate to support their exposure at all times.

In case, a member fails to deliver the shares sold in rolling settlement, the exchange conducts an auction session on T+2, to meet the shortfall created by non-delivery of shares. In this auction session, offers are invited from the other members to deliver the shares sold by originally selling member, since delivery has to be made to the buying member. In case no shares are received in auction, the sale transaction is closed-out at a close-out price, determined by higher of the following:

- Highest price, recorded in the scrip from the settlement in which the transaction took place upto a day prior to the auction.

  OR

- 20% above the closing price on a day prior to the auction.

In this case, the auction price/ close-out and difference between sale price, if positive is payable by the seller who failed to deliver the scrips. In case, auction/ close out price is less than sale price, the difference is not given to the seller, but is credited to investor protection fund.

Question 11

Write short notes on the following:

(a) Securities Transaction Tax.

(b) Price/Earnings (P/E) ratio. *(4 Marks each, May, 2008)*

Answer

(a) Security Transaction Tax (STT): In the union budget for 2004-05, Government has introduced Security Transaction Tax to be levied on all transactions done on stock exchanges. As per the provisions of the Finance Bill, the stock exchanges have been entrusted with the responsibility of levy, collection and remittance of the STT on all transactions from the date of notification by the Government of India.

SEBI vide its Circular no. MRD / DOP /Cir – 28 / 2004 dated August 23, 2004 directed that no stock exchange shall permit trading activities unless it implements necessary software and procedures for the levy, collection and remittance of STT.

(b) Price/Earning Ratio: The pre-issue price/earning ratio should be calculated by using the following formula:

$$\frac{\text{Issue price per share}}{\text{Earning per share}} \times 100$$

The issue price per share which is to be used for computing this ratio (and not the market price per share which is normally used for computation of the price/earning ratio).

Accordingly, for this purpose issue price per share is required to be used. However, P/E ratio of the company based on issue price is to be compared with the industry P/E ratio, based on market price. For the purpose of the industry P/E ratio, the auditor should check that the market price should be the market price for the industry prevailing within one month prior to the date of auditor's report or as close thereto as possible.

Question 12

State the items contained in the SEBI's check list for auditors in respect of contract notes issued by a Stock Broker. *(8 Marks, May, 2007)*

Answer

SEBI's check list for auditors in respect of contract notes issued by a Stock Broker:

(i) Members should issue Contract Notes to his clients for all trades executed by him on their behalf.

(ii) The member should stamp his order sheets/records and the order time should be reflected in the Contract Note along with the time of execution of order.

(iii) The Contract Notes should bear SEBI Registration number of the member. It should be pre-printed with serial numbers and issued within 24 hours of trade execution. Appropriate stamps should be affixed on the contract Note. Duplicate copies of the contract note should be maintained.

(iv) The Contract Note should be signed by the member or his constituted attorney.

(v) Contract note issued to the clients should show the brokerage separately.

(vi) In case the broker acts as a principal, the Contract Note should be in Form B.

(vii) Consent of the client should be taken for any trade done by the broker while acting as a principal.

(viii) Brokerage should be within the limits prescribed by the exchange.

Question 13

Write short notes on Contents of Audit report of Mutual Fund. *(4 Marks, May, 2007)*

Answer

Audit report of mutual fund: It comprises the following-

(i) The auditor has obtained all information and explanations which, to the best of his knowledge and belief, were necessary for the purpose of the audit.

(ii) The balance sheet and the revenue account give a fair and true view of the scheme, state of affairs and surplus or deficit in the fund for accounting period to which the balance sheet or, as the case may be, the revenue account relates.

(iii) The statement of account has been prepared in accordance with accounting policies and standards as specified in the ninth schedule.

Question 14

Enumerate the main areas to be covered by the auditor in the case of environment audit of an industrial unit. *(8 Marks, November, 2006)*

Answer

Main areas to be covered in the case of environment audit of an industrial unit:

(i) Layout and Design – The layout to be sketched in the style which will allow adequate provisions for installing pollution control devices, as well as provision for up gradation of pollution control measures and the meeting of the requirements of the regulations framed by the Government. In the course of the audit, the area which requires attention but not attended to by the industry to be pinpointed as well as the future requirements of the environmental measures required in commensuration with the proposed future course of working plan are to be identified.

(ii) Management of Resources – Management resources includes air, water, land, energy, raw materials and human resources besides others. The use of all resources is interlinked and the best uses in a synchronised manner results the best output and minimum waste. The waste of resources to the minimum possible extent is good for the health of the industry as well as the environment.

(iii) Pollution Control System – An effective system of pollution control should be in existence. One aspect should be whether all required pollution control measures are in vogue or not next aspect should be whether the same is effective or not, further it is to investigate, whether more measures are required, keeping ill view the type of industry and it's nature of working with respect to its grade of polluting the environment.

(iv) Emergent Safety Arrangement – The chemical, gas, etc., industries which are prone to sudden requirement of safety arrangements, must remain alert all the while. The emergency plans are to be reviewed periodically; sufficient staff along with other required safety amenities should be kept ready. The staff, remained so engaged, must possess the required awareness and alertness to meet the contingency. The degree of awareness, however, can be upgraded with proper training provisions.

(v) Medical & Healthcare Facilities – The medical services should be maintained. The health of the workers should be a big consideration for the management.

(vi) Industrial Hygiene – Proper system should be in vogue to eliminate industrial unhygienic state.

(vii) Occupational Health – The requirement for safeguarding against occupational health hazards should be available for all the workers. As the occupational health hazards varies from industry to industry due to the difference in the nature of working atmosphere and the pollutants present in it, the concerned industry must pay proper weightage to those diseases which are prone to that particular type of industry.

(viii) Information Assimilation and Reporting System – The information system should be strengthened to generate and its reporting system should be proper, keeping in view, the authorities, responsibilities and subsequent delegations. A report of compliance of all statutory environmental laws along with other preventive and precautionary measures should be put to Board at regular intervals.

(ix) EIA Methodology – The Environmental Impact Assessment (EIA) is usually are pre-requisites to start an industry. This is done considering the known spheres of activities on the existing environmental conditions. But the predictions necessarily deviate from the actual happenings when the industry starts working. To accommodate the deviation in the system is also to be incorporated in the EIA report, if it is noticed that the degradation to the environment caused on the establishment and running of the industry is much higher than what was predicted, the mitigatory measures suggested must also be furthered.

(x) Compliance to the Regulatory Mechanism – As the persons who are directly working with the system, may be unaware of the latest developments and requirements for the compliance of stipulations and standards prescribed by the various regulatory authorities, they should be trained and instructed on regular basis, to avoid making the Board/owner vulnerable to prosecution and penalty.

(xi) Concern for the Society – The industry very often transforms the agrarian environment into an industrial environment. The people so displaced by industrialisation feel alienated and develop a feeling of facing the gaseous, dustful, clumsy state of surroundings. The audit should look into this aspect how the industry is making a balance between its own development and the society's concern.

Question 15

Write short notes on Types of market under NEAT (National Exchange Automated Trading).

(4 Marks, November, 2006)

Answer

Type of markets under NEAT (National Exchange Automated Trading)-

(i) **Normal Market:** All orders of regular lot size or multiples thereof are traded in the normal market. Normal market consists of regular lot orders, special term orders, negotiated trade order and stop loss order depending on their order tributes.

(ii) **Odd Lot Market:** If the order size is less than the regular lot size such orders are traded in the odd lot market. In an odd lot market both the price and quantity of both the orders (buy and sell) should exactly match for the trade to take place.

(iii) **Spot Market:** Spot orders are similar to normal market orders except that spot orders have different settlement periods vis-a-vis normal market.

(iv) **Auction Market:** In the auction market, auctions are initiated by the exchange on behalf of trading members, for completing the settlement process.

Question 16

Write short notes on Disclosure under "Basis of Issue Price" in prospectus.

(4 Marks, May, 2006)

Answer

Disclosures under 'Basis of Issue Price': Under this heading, the following information is to be disclosed-

(i) Earnings per share, i.e., EPS pre-issue for the last three years (as adjusted for changes in capital).

(ii) P/E pre-issue.

(iii) Average return on net worth in the last three years.

(iv) Minimum return on the increased net worth required to maintain pre-issue EPS.

(v) Net Asset Value per share based on last balance sheet.

(vi) Net Asset Value per share after issue and comparison thereof with the issue price.

(vii) Comparison of all the accounting ratios of the issuer company as mentioned above with the industry average and with the accounting ratios of the peer group (i.e., companies of comparable size in the same industry (indicate the source from which industry average and accounting ratios of the peer group has been taken).

(viii) The face value of shares (including the statement about the issue price/ floor price/ price band being "X" times of the face value).

Provided that the projected earnings shall not be used as a justification for the issue price in the prospectus.

Provided further that the accounting ratios disclosed in the prospectus in support of basis of the issue price shall be calculated after giving effect to the consequent increase in capital on account of compulsory conversions outstanding, as well as on the assumption that the options outstanding, if any, to subscribe for additional capital will be exercised.

Question 17

Write short notes on the following:

(a) Vostro and Nostro Accounts.

(b) Margins (Under Stock Exchange Trading Regulations). (4 Marks each, May, 2005)

Answer

(a) Vostro and Nostro Accounts: Bank's maintain stocks of foreign currencies in the form of Bank Accounts with their overseas branches/correspondents. Such foreign currency accounts maintained by Indian banks at other overseas centres is designated by it as "Nostro Account". For example all banks in India would be maintaining a US Dollar Account with their New York office/branch/correspondents, such account would be designated by the Indian office as Nostro Account. "Vostro Account" is the opposite of

Nostro accounts. Here a foreign bank in another country maintains stocks of Indian rupees with their Indian branch/correspondent/local bank. Such Indian Rupee Accounts are designated as a Vostro Account. For example a German Bank might maintain a Vostro Account in rupees in terms with Indian Bank. While examining the transaction in foreign exchange, the auditor should also pay attention to reconciliation of Nostro Accounts with the respective minor account. The amount in the Nostro account is stock of foreign currency in the form of bank accounts with the overseas branches and correspondents. Unreconciled Nostro Accounts, on an examination, may reveal unauthorized payments from the foreign currency account, unauthorized withdrawals, and unauthorized debit to minor account. The auditor should also evaluate the internal control with regard to inward/ outward messages. The inward/ outward messages should be properly authenticated and discrepancies noticed, should be properly dealt with, in the books of accounts.

The auditor should also verify whether prescribed procedure in relation to interbank confirmation in the Vostro account is followed or not. In case balance confirmation certificate have been received but the same have not been reconciled, or where confirmation has not been received the same should be reported, in respect of each Vostro Account.

(b) Margins: Margin refers to deposit made by members with the stock exchange authorities. There can be wide fluctuations at the time of settlement in the prices of securities since the closing rate of the earlier settlement. In order to restrict excessive speculation and also to safeguard the interest of the investors, members are required to keep certain deposits with the stock exchange. The members are required to collect the margin from their clients and deposit the same with clearing house. Margin is intended to protect the members by providing them with funds to cover anticipated fluctuations in prices of securities, particularly, if the client delays or is unable to meet his commitments. It also helps prevent excessive speculation, as clients would be required to invest some funds and not indulge in speculations without adequate resource. Different type of margins which a member is normally required to deposit are: Gross exposure margin, Mark to market margin, Volatility margin, Additional Volatility margin, Special margin and Ad-hoc margin. These margins are required to be paid on due dates at stipulated time as decided by the exchange or clearing house of the exchange. The members are required to compute margin payable for all the securities traded by them.

Question 18

Write short notes on Sauda Book. *(4 Marks, November, 2004)*

Answer

Sauda Book: All members of a stock exchange are required to maintain a 'Sauda Book', which contains details of all deals transacted by them on a day to day basis. This is a basic record, which each member is required to maintain regularly on day-to-day basis. It contains the details regarding the name of the code of the client on whose behalf the deals have been done, rate and quantity of bought or sold. These details are maintained date-wise. This register contains all the transactions, which may be of any of the kind mentioned below:

(i) member's own business on the Exchange,

(ii) member's business on the Exchange on behalf of clients,

(iii) member's business with the clients on principal-to-principal basis,

(iv) member's business with the members of other Stock Exchanges,

(v) member's business on behalf of his clients with the members of other Stock Exchanges,

(vi) spot transactions, etc.

Question 19

Write short explanatory notes on Human Resource Accounting. *(4 Marks, May, 2004)*

Answer

Human Resource Accounting: Human resource is perhaps the most valuable asset in an undertaking. Flamholtz defines human resource as "accounting for people as an organizational resource. It involves measuring the costs incurred by business firm and other organizations to recruit, select, hire, train and develop human assets. It also includes measuring the economic value of people to organisations". This definition gives two methods of valuing human resources, i.e., cost and the economic value. A company may value its human resources on the cost basis, i.e., at the costs incurred by it in procuring and developing these assets. Another method is to work out the replacement values of persons, representing the economic value. According to Flamholtz, an individual possesses value for an organisation because he is capable of rendering future services. Theoretically, therefore, his value to an organisation is equal to the present worth of his expected future services. Thus, an individual's value to an organisation can be defined as the present worth of the set of future services that the person is expected to provide during the period he is anticipated to remain in the organisation. In this connection, putting a monetary value on human resources presents a lot of practical problems particularly from the auditor's view point because of element of subjectivity is inherent in the process of such valuation.

18

Audit of Public Sector Undertakings

Question 1

What are the principles involved regarding "Propriety audit' in the case of Public Sector Undertaking?

Answer

Companies Act, lays down special provisions regarding audit of accounts of public sector undertakings registered as Government Companies. Section 143 of the Companies Act, 2013 empowers C&AG to conduct supplementary or test audit. Audit of public enterprises in India is not restricted to financial and compliance audit; it extends also to efficiency, economy and effectiveness with which these operate and fulfill their objectives and goals. Another aspect of audit relates to questions of propriety; this audit is directed towards an examination of management decisions in sales, purchases, contracts, etc. to see whether these have been taken in the best interests of the undertaking and conform to accepted principles of financial propriety. Propriety audit stands for verification of transactions on the tests of public interest, commonly accepted customs and standards of conduct. On an analysis, these tests boil down to tests of economy, efficiency and faithfulness. Instead of too much dependence on documents, vouchers and evidence, it shifts the emphasis to the substance of transactions and looks into the appropriateness thereof on a consideration of financial prudence, public interest and prevention of wasteful expenditure. Thus, propriety audit is concerned with scrutiny of executive actions and decisions bearing on financial and profit and loss situation of the company, with special regard to public interest and commonly accepted customs and standards of conduct. It is also seen whether every officer has exercised the same vigilance in respect of expenditure incurred from public money, as a person of ordinary prudence would exercise in respect of expenditure of his own money under similar circumstances. Some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

(i) The expenditure should not be prima facie more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.

(ii) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

(iii) Public moneys should not be utilised for the benefit of a particular person or section of the community.

(iv) Apart from the agreed remuneration or reward, no other avenue is kept open to indirectly benefit the management personnel, employees and others.

It may be stated that it is the responsibility of the executive departments to enforce economy in public expenditure. The aim of propriety audit is to bring to the notice of the proper authorities of wastefulness in public administration and cases of improper; avoidable and in fructuous expenditure.

Question 2

Write a short note on - Propriety Audit.

Answer

Propriety Audit: Propriety Audit stands for verification of transactions on the tests of public interest commonly accepted customs and standards of conduct. E.L. Kohler has defined the term propriety as "that which meets the tests of public interest, commonly accepted customs and standards of conduct, and particularly as applied to professional performance, requirements of law, government regulations and professional codes". Instead of too much dependence on documents, vouchers and evidence, it shifts the emphasis to the substance of the transactions and looks into the appropriateness thereof on a consideration of financial prudence, public interest and prevention of wasteful expenditure. Thus propriety audit is concerned with scrutiny of executive actions and decisions bearing on financial and profit and loss situation of the company with special regard to public interest and commonly accepted customs, and standards of conduct. It is also seen whether every offer has exercised the same vigilance in respect of expenditure incurred from public money, as a person of ordinary prudence would exercise in respect of expenditure of his own money under similar circumstances. Propriety requires the transactions, and more particularly expenditure, to conform to certain general principles. These principles are:

(i) that the expenditure is not prima facie more than the occasion demands and that every official exercises the same degree of vigilance in respect of expenditure as a person of ordinary prudence would exercise in respect of his own money;

(ii) that the authority exercises its power of sanctioning expenditure to pass an order which will not directly or indirectly accrue to its own advantage;

(iii) that funds are not utilised for the benefit of a particular person or group of persons and

(iv) that, apart from the agreed remuneration or reward, no other avenue is kept open to indirectly benefit the management personnel, employees and others.

Question 3

What is a comprehensive audit of public enterprises? Discuss some of the areas to be examined therein.

Answer

Comprehensive Audit of Public Enterprises: Areas to be examined: The scope and extent of audit of public sector enterprises is determined by the Comptroller and Auditor General of India. Audit of public enterprises in India is not restricted to financial and compliance audit; it

extends also to efficiency, economy and effectiveness with which these operate and fulfil their objectives and goals. Another aspect of such audit relates to questions of propriety; this audit is directed towards an examination of management decisions in sales, purchases, contracts, etc. to see whether these have been taken in the best interests of the undertaking and conform to accepted principles of financial propriety. Comprehensive audit involves assessing efficiency and effectiveness of public enterprises in its entirety to be conducted on the basis of certain standards and criterion. Public enterprises have been set-up with socio-objectives. An objective assessment with reference to such objectives' fulfillment would require comprehensive audit.

The starting point of a comprehensive audit of a public enterprise, which covers aspects of economy, efficiency and effectiveness, is the preparation of an audit programme based on the study of decisions relating to the setting up of the enterprise, its objectives, the areas of operation, organisation, financial and operational details available in the annual reports and accounts, capital and operational budgets, deliberations of the board of directors, material in the earlier audit inspection reports on the enterprise and other relevant available papers. These audit programmes (or guidelines) identify the areas/aspects which require further detailed audit analysis and criteria, the data required for such analysis and the sources of such data, the extent of the audit analysis including the test checks to be applied and the instructions to the audit parties assigned to the work.

The areas covered by comprehensive audit are those of investment decisions, project formulation and management, organisation, delegation of powers and management information systems, organisational effectiveness, capacity utilisation, management of equipment, plant and machinery, production performance, use of materials, productivity of labour, idle capacity, costs and prices, development of complementary ancillary small scale industries, materials management, sales and credit control, budgetary and internal control systems, etc. The areas covered in comprehensive audit will naturally vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations. Some of the broad areas are listed below:

- Comparison of overall capital cost of the project with the approved planned costs.
- Production or operational outputs vis-a-vis under-utilisation of the installed capacity.
- Systems of project formulation and implementation.
- Planned rate of return
- Cost control measures.
- Research and development programmes.
- System of repairs and maintenance.
- adequate purchase policies
- Effective and economical procedures
- Project planning
- Undue waste, unproductive time for men and machines, wasteful utilisation or even non-utilisation of resources

Question 4

Write a short explanatory note on - Areas of propriety audit under Section 143(1) of the Companies Act, 2013.

Answer

Areas of propriety audit under Section 143(1): Section 143(1) of the Companies Act, 2013 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:

(a) 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 prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company; Again, considering the propriety element, rationalizing the proper disclosure of loans and advance given by company is made;

(c) where the company not being an investment company 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;

(d) whether loans and advances made by the company have been shown as deposits;

(e) whether personal expenses have been charged to revenue account;

(f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet 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.

Question 5

Write short notes on the Role of C&AG in the Audit of a Government company.

Answer

Role of C&AG in the Audit of a Government company: Role of C&AG is prescribed under sub section (5), (6) and (7) of section 143 of the Companies Act, 2013.

In the case of a Government company, the comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 i.e. appointment of First Auditor or Subsequent Auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited and

thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

The Comptroller and Auditor-General of India shall within sixty days from the date of receipt of the audit report have a right to,

(i) conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct; and

(ii) Comment upon or supplement such audit report:

Provided that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

Test Audit: Further, without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor- General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

Question 6

ABG & Co., a Chartered Accountant firm has been appointed by C & AG for performance audit of a Sugar Industry. What factors should be considered by ABG & Co., while planning a performance audit of Sugar Industry?

Answer

Factors to be considered while planning the Performance Audit: While planning a performance audit of Sugar Industry, the auditors should take care of certain factors which are listed below:

(i) to consider significance and the needs of potential users of the audit report.

(ii) to obtain an understanding of the program to be audited.

(iii) to consider legal and regulatory requirements.

(iv) to consider management controls.

(v) to identify criteria needed to evaluate matters subject to audit.

(vi) to identify significant findings and recommendations from previous audits that could affect the current audit objectives. Auditors should determine if management has corrected the conditions causing those findings and implemented those recommendations.

(vii) to identify potential sources of data that could be used as audit evidence and consider the validity and reliability of these data, including data collected by the audited entity, data generated by the auditors, or data provided by third parties.

(viii) to consider whether the work of other auditors and experts may be used to satisfy some of the auditors' objectives.

(ix) to provide sufficient staff and other resources to do the audit.

(x) to prepare a written audit plan.

18

Audit of Public Sector Undertakings

Question 1

Write short notes on the following:

(a) Areas of proprietary audit under section 227(1A) of the Companies Act, 1956.

(b) Supplementary audit under section 619(3) of the Companies Act, 1956.

(4 Marks each, November, 2012)

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) This question is redundant in view of the provisions of the Companies Act, 2013.

Question 2

Write short notes on the following:

(a) Comptroller & Auditor General of India were conducting supplementary audit U/s 619 (3) (b) of the Companies Act, 1956 made certain comments on the reported foreign exchange loss in the accounts of a Public sector company. The Board of Directors failed to reply to the comments of C & AG in their report- Comment. (4 Marks, November, 2011)

(b) Propriety elements in CARO 2003. (4 Marks, November, 2011)

Or

Explain the propriety elements in the Companies (Auditors) Report Order, 2003.

(8 Marks, November, 2006)

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) This question is redundant in view of the provisions of the Companies Act, 2013.

Question 3

Write short notes on General principles of propriety audit. (4 Marks, May, 2011)

Or

Write short notes on General principles relating to propriety aspect. (4 Marks, November, 2008)

Answer

General principles of Propriety Audit: Proprietary audit is concerned with scrutiny of executive actions and decisions bearing on financial and profit and loss situation of the company, with special regard to public interest and commonly accepted customs and standards of conduct.

General principles of Propriety Audit are as under:

(i) That the expenditure is not prima facie more than the occasion demands and that every official exercises the same degree of vigilance in respect of expenditure as a person of ordinary prudence would exercise in respect of his own money.

(ii) That the authority exercises its powers of sanctioning expenditure which will not result in any benefit directly or indirectly to such authority.

(iii) That the funds are not utilised for the benefit of a particular person or group of persons and

(iv) That, apart from the agreed remuneration or reward, no other revenue is kept open to indirectly benefit the management personnel, employees or others.

Question 4

Write short notes on Supplementary Audit u/s 619(4) of the companies Act, 1956.

(4 Marks, November, 2007)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 5

Write short notes on Public Accounts Committee. (4 Marks, May, 2007)

Answer

Public Accounts Committee (PAC): The parliament as well as each state legislative sets up a public accounts committee to scrutinize the appropriation accounts and the report of the auditors thereon. The committee also examines financial statements (together with the auditors' report thereon) of the State Corporation and other autonomous and semi- autonomous bodies (except Government companies and those public undertakings which assigned to the committee on public undertakings). The Public Accounts Committee satisfies itself:

(i) that the moneys (shown in the accounts) were disbursed legally on the service or purpose to which they were applied.

(ii) that the expenditure was authorised.

(iii) that re-appropriation (i.e. distribution of funds).

19

Internal Audit, Management and Operational Audit

Question 1

JKT Pvt. Ltd. having ₹ 40 lacs paid up capital, ₹ 9.50 crores reserves and turnover of last three consecutive financial years, immediately preceding the financial year under audit, being ₹ 49 crores, ₹ 145 crores and ₹ 260 crores, but does not have any internal audit system. In view of the management, internal audit system is not mandatory. Comment.

Answer

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, read with rule 13 of Companies (Audit and Auditors) Rules, 2014 every private company shall be required to appoint an internal auditor or a firm of internal auditors, having-

(i) turnover of two hundred crore rupees or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year:

In the instant case, JKT Ltd. is having turnover of Rs. 260 crores during the preceding financial year which is more than two hundred crore rupees. Hence, the Company has the statutory liability to appoint an Internal Auditor and mandatorily conduct internal audit.

Question 2

Briefly explain the objectives and scope of Operational Audit.

Answer

Objectives of Operational Audit: The need for operational auditing has arisen due to the inadequacy of traditional sources of information for an effective management of the company where the management is at a distance from actual operations due to layers of delegation of responsibility, separating it from actualities in the organisation. Specifically, operational auditing arose from the need of managers responsible for areas beyond their direct observation to be fully, objectively and currently informed about conditions in the units under control. Operational audit is considered as a specialised management information tool to fill the void that conventional information sources fail to fill. Conventional sources of management information are departmental managers, routine performance report, internal audit reports, and periodic special investigation and survey. These conventional sources fail to provide information for the best direction of the departments all of whose activities do not come under direct observation of managers.

Operational auditing has filled a very significant vacuum; it has come to provide the management with inexpensive, continuous and objective appraisal of activities, operations and controls to inform the management about achievement of standards and, if otherwise, to inform the management about what has gone wrong and how it has gone wrong. Also, it enlightens the management about possible dangers, constraints and opportunities that may be of immense value to the management.

The scope and quality of operational auditing is predominantly dependent upon management attitudes. An open minded management with broad vision, can appreciate the need of operational auditing and to give it the necessary freedom and sanction to perform what it is capable of performing. Also, the qualities and the sense of perspectives of the operational auditor can mould operational audit in the right shape. Without a combination of these two, operational auditing may not be able to show its distinctively and advantages to the organisation. Therefore, there is a possibility of operational auditing having different objectives to fulfil in different organisations. Generally, operational audit objectives include:

(i) Appraisal of controls: Operations and the results in which management is interested are largely a matter of control. If controls are effective in design and are faithfully adhered to the result that can be attained will be subject to the other limiting constraints in the organization.

(ii) Evaluation of performance: In the task of performance evaluation, an operational auditor is heavily dependent upon availability of acceptable standards. The operational auditor cannot be expected to possess technical background in so many diverse technical fields obtaining even in one enterprise. Even when examining or appraising performance or reports of performance, the operational auditor's mind is invariably fixed on control aspects.

(iii) Appraisal of objectives and plans: In performance appraisal, the operational auditor is basically concerned not so much with how well technically the operations are going on, but with accumulating information and evidence to measure the effectiveness, efficiency and economy with which the operations are being carried on.

(iv) Appraisal of organisational structure: Organisational structure provides the line of relationships and delegation of authority and tasks. This is an important element of the internal control design. In evaluating organisational structure, the operational auditor should consider whether the structure is in conformity with the management objectives and it is drawn up on the basis of matching of responsibility and authority. He should also analyse whether line of responsibility has been fixed, whether delegation of responsibility or authority is clear and there is no overlapping area.

Question 3

What are the Management Audit Questionnaires? Give a sample questionnaire for Audit of Inventory.

Answer

Management Audit Questionnaire: A management audit questionnaire is an important tool for conducting the management audit. It is through these questionnaires that the auditors make an inquiry into important facts by measuring current performance. Such questionnaires aim at a comprehensive and constructive examination of an organisation's management and its assigned tasks. Overall it is concerned with the appraisal of management actions in accomplishing the organisation's objectives. Its primary objective is to highlight weaknesses and deficiencies of the organisation. It includes a review of how well or badly the management functions of planning, organising, directing and controlling are being performed. In addition it evaluates how effective the decision-making process is accomplishing the stated organisation objectives. Within this framework, the questionnaire provides a means for evaluating an organisation's ongoing operations by examining its major functional areas. There are three possible answers to the management audit questions: "Yes", "No" and "N.A.", (not applicable). A "Yes" answer indicates that the specific area, function, or aspect under study is functioning in an acceptable manner; no written explanation is needed in that case. On the other hand, a "no" answer indicates unacceptable performance and should be explained in writing. Questionnaire comments on negative answers not only provide documentation for future reference, but, more important, provide background information for undertaking remedial action. Those questions that are not applicable and should be ignored in the audit are checked in the "N.A." column. The management audit questionnaire does not give answers, but simply asks questions. If all questions are answered with a 'yes', operations are proceeding as desired. On the other hand, if there are one or more 'no' answers, difficulties are being experienced and must be explained in writing. If the question does not apply, the N.A. (not applicable) column is checked. Thus, management audit questionnaire for this part of the audit not only serves as a management tool to analyse the current situation; more importantly, it enables the management auditors to synthesis those elements that are causing organisational difficulties and deficiencies.

Audit of Inventory

A management audit questionnaire for audit of inventory is given below :

Questionnaire	Yes	No	N.A.
INVENTORY			
A. Long-range plans:			
1. Is inventory management sufficiently qualified to meet long-range company objectives?			
2. Are long-range inventory management plans coordinated with:			
a. production?			
b. purchasing?			
c. finance?			
3. Is inventory properly and efficiently stored so as to provide a minimum of:			
a. obsolescence?			
b. deterioration?			
c. pilferage?			
4. Is there an adequate inventory system under management control to plan inventory in the long run at optimum levels?			
5. Is there an effective physical inventory system to obviate any surprises in loss or value?			
6. Are inventory plans and procedures audited periodically by:			
a. internal auditors?			
b. external auditors?			
B. Short- or medium-range plans:			
1. Is inventory management sufficiently qualified to meet short- or medium-range company objectives?			
2. Are short-range inventory management plans an integral part of-			
a. production?			
b. purchasing?			
3. Are inventories under control as to:			
a. type?			
b. amount?			
4. Is there an adequate inventory system to:			
a. plan current inventory at optimum levels?			
b. compare physical to perpetual inventories?			
c. detect theft?			
5. Are lead times figured into inventory levels for:			
a. purchasing?			
b. manufacturing?			
6. Is the concept of safety stock employed as a protection against stock-outs?			
7. Are inventory levels coordinated with reorder points?			
8. Are bills of materials utilized to determine inventory requirements?			
9. Do short-range inventory plans include "make" versus "buy" decisions to lower costs?			
10. Is receiving and inspection of inventory items ade-			

	quate?			
C.	**Organisational structure:**			
1.	Is the inventory department under the direction of a capable manager?			
2.	Are inventories and their in-plant movements organised and reported by their basic types:			
	a. raw materials?			
	b. work in process?			
	c. finished goods?			
3.	Are inventories maintained at their optimum level by their basic types: a. raw materials?			
	b. work in process?			
	c. finished goods?			
4.	Is there an effective system of physical inventory to disclose any irregularities or losses?			
5.	Is inventory organised around the ABC method of classifying materials, i.e., by high, medium, and low-value items?			
6.	Is inventory integrated within an information system?			
7.	Are modern materials-handling methods used for transportation and storage of materials?			
D.	**Leadership:**			
1.	Does inventory management exert the necessary leadership to keep inventory under control?			
2.	Is inventory management capable of giving the leadership necessary to minimise the investment in:			
	a. raw-materials inventories?			
	b. work-in-process inventories?			
	c. finished-goods inventories?			
3.	Is inventory kept at a minimum that is consistent with efficient production planning?			
4.	Does inventory management have the necessary clout to store inventories properly in order to minimize losses caused by spoilage, obsolescence, or depreciation?			
5.	Is inventory management sufficiently progressive to employ the most modern materials-handling methods for transportation and storage of inventories?			

E.	**Communication:**			
1.	Is there an information system utilised that employs efficient management, methods and techniques to control inventories and to prepare periodic inventory reports that are of great value to management?			
2.	Is there an effective communication system designed to assist in, keeping the inventory turnover rate high?			
3.	Is there good managerial control over movement of work-in-process materials so that this inventory is kept at a minimum?			
4.	Is the level of work-in-process materials consistent with an efficient manufacturing cycle?			
5.	Is there a procedure for highlighting excess inventory quantities and bringing this condition to management's attention in order to return them to their proper levels?			
6.	Is there an effective inventory system for keeping any surprises in inventory losses to minimum?			
F.	**Control:**			
1.	Are inventory management control reports, methods, and techniques integrated with:			
	a. production?			
	b. purchasing?			
2.	Are inventories effectively controlled as to:			
	a. type?			
	b. amount?			
3.	Are inventories properly stored to provide a minimum of.			
	a. obsolescence?			
	b. deterioration?			
	c. pilferage?			
4.	Have inventory levels been reduced by profitable disposition of obsolete or excess items?			
5.	Is inventory control integrated with:			
	a. economic order quantities?			
	b. reorder points?			
6.	Is the concept of safety stock employed to protect against stockouts?			
7.	Are lead times figured into inventory levels?			

8. Have steps been taken to balance the cost generated by too small an inventory against the cost of carrying excessive inventories to determine an optimum inventory turnover?			
9. Are bills of materials utilised to determine what items should be retrieved from inventory?			
10. Is there adequate management control over the receipt of raw materials and parts from vendors?			
11. Is there adequate management control over the receipt of work-in- process items for the manufacturing departments?			
12. Is there adequate inspection of items received into inventory as to:			
a. type?			
b. number?			
13. Are inventory items physically counted to make sure that perpetual inventory records are accurate?			
14. Is inventory controlled through the use of the ABC concept (A = high-value items, B = medium-value items, C = low-value items)?			
15. Is there an effective management control system for receiving materials that are not on a purchase order, i.e., products returned by customers?			
16. Are materials available when needed for the start of production?			

Question 4

"Operational auditing is not different from internal auditing." Discuss.

Answer

Internal auditing is an activity carried out by the internal staff of the organisation to meet the management requirements of information. The definition of internal auditing as given by the Institute of Internal Auditors of New York, in fact, is so wide in its scope that it covers both operational and management auditing. According to the Institute of Internal Auditors, "the overall objective of internal auditing is to assist all members of management in the objective discharge of their responsibilities, by furnishing them with objective analysis, appraisals, recommendations and pertinent comments concerning the activities reviewed. The internal auditor, therefore, should be concerned with any phase of business activity wherein he can be of service to organisation". According to the definition, the overall objective of internal auditing is to assist all members of management in the objective discharge of their responsibilities, by furnishing them with objective analysis, appraisals, recommendations and relevant comments concerning the activities reviewed. The internal auditor, therefore, should be concerned with any phase of business activity wherein he can be of service to the organisation. Naturally, when an auditor is concerned with the appraisal of operations, he would be performing the role of an operational auditor. Another important point that this definition throws up is that operational auditing is essentially a function of internal auditing staff. Traditionally, the internal auditing was concerned with the financial transactions only. It was during early 1940's, the concept of operational auditing came into existence. According to Cadmus "operational auditing is not different from internal auditing, it is merely an extension of internal auditing into operational areas. It is characterised in both financial and operational areas – by the auditor's approach and state of mind". The main objective of operational auditing is to verify the fulfillment of plans and sound business requirements as also to focus on objectives and their achievement as against the performance yardsticks evident from in the management objectives, goals and plans, budgets records of past performance, policies and procedures. Industry standards can be obtained from the statistics provided by industry, associations and government sources. It should be appreciated that the standards may be relative depending upon the situation and circumstances; the operational auditor may have to apply them with suitable adjustments. It might appear from the above that an internal auditor is not concerned with operational aspects and operational auditor is, not concerned with financial aspects which is not so. Because traditionally, internal auditors had been engaged in a sort of protective function, deriving their authority from the management. They examined internal controls in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are not there; they checked the accounting books and records to see, whether the internal checks are properly working and the resulting accounting data are reliable. They also looked into the aspect of safety of the assets and properties of the company. Some element of operational auditing could be found even in these traditional functions of internal auditors, specially in the context of fraud, wastage and loss. Internal auditors emboldened by their ability to appraise financial and accounting control gradually started extending their field to cover non-accounting control as well. On the other hand, it should not be assumed, that, since an operational auditor is concerned with the audit of operations and review of operating conditions, he is not concerned with the financial aspects of transaction and controls. A point has already been made that the special expertise acquired by the operational auditor, that enables him to view the controls and operations from the management point of view, can be carried back to his review of the financial areas. In the matter of cash transactions, the operational auditor will look into such aspects as the quantum of cash in hand (by relating it to the requirement of cash to be held) carried generally or the use of cash not immediately required. Also he will review the operational control on cash to determine whether maximum possible protection has been given to cash. Similarly, in the audit of inventories, he would have management policy. In pure administrative areas on inventory, he will see whether adequate security and insurance arrangements exist for protection of inventories.

Thus, over a period of time, the scope of internal auditing was widened to cover not only accounting and financial operations but other operations such as marketing, personnel, production, etc. As per the modern definition of internal auditing, there is no difference between the two. However, still some auditors believe that there might exist difference between the two on account of perception as far as scope of the two is concerned which in

fact is not true as evident from the foregoing analysis.

Question 5

Explain in brief the behavioural aspects encountered in the management audit and state the ways to solve them.

Answer

Behavioural aspects encountered in Management Audit: Financial auditors deal mainly with figures. Management auditors deal mainly with people. There are many causes for behavioural problems arising in the review function of management audit. Particularly, when management auditors performs comprehensive audit of operations, they cannot be as well informed about such operations as a financial auditor in a financial department. Operating processes may be unfamiliar and complex. The operating people may be speaking a language and using terms that are foreign to the auditor's experience. The nature and causes of behavioural problems that the management auditor is likely to face in the discharge of the review function that is expected of him and possible solutions to overcome these problems are discussed below:

(1) **Staff / Line conflict**: Management auditors are staff people while the members of other departments are line people. Management auditors tend to discount the difficulties the line staff may face, if called on to act on the ideas of management auditors. Management auditors are specialists in their field and they may think their approach and solutions are the only answers.

(2) **Control**: The management auditor is expected to evaluate the effectiveness of controls, there is an instinctive reaction from the auditee that the report of the auditor may affect them. There is a fear that the action taken based on the management audit report will affect the line people. It breeds antagonism. The causes are as under:

   (i) Fear of criticism stemming from adverse audit findings.

   (ii) Fear of change in day to day working habits because of changes resulting from audit recommendations.

   (iii) Punitive action by superior prompted by reported deficiencies.

   (iv) Insensitive audit practices.

   (v) Hostile audit style.

Solution to behavioural problems: The following steps may be taken to overcome the aforesaid problems:

(i) To demonstrate that audit is part of an overall programme of review for protective and constructive benefit.

(ii) To demonstrate the objective of review is to provide maximum service in all feasible managerial dimensions.

(iii) To demonstrate the review will be with minimum interference with regular operation.

(iv) The responsible officers will be involved in the process of review of the findings and recommendations before the audit report is formally released.

It is essential to create an atmosphere of trust and friendliness so that audit reports will be understood in their proper perspective.

Finally, it needs hardly any emphasis that there should be right management culture, enlightened auditees and auditors of the right calibre. May be to expect a combination at all times of all the three is asking for the impossible. But, a concerted effort by the management, auditors and auditees to achieve a more acceptable climate would go a long way to achieve the goal.

Question 6

K Ltd. requires you to organize a Management audit program. Briefly state a plan of action.

Answer

Organizing a Management Audit for K Ltd.: The key requirement for a successful Management audit program would be the approval and support of the top management to initiate. Accordingly the following shall be the matters that should be considered while organizing the Management Audit of K. Ltd.

Devising the statement of policy - The management's support must be reflected clearly and categorically in the company's highest policy statement. The policy statement should be quite specific. It should spell out clearly the scope and status of the management/operational auditing within the enterprise, its authority to carry out audits, issue reports, make recommendations, and evaluate corrective action. The statement of policy should lay down in clear terms the scope of activities to be performed by the management auditor. The scope of activities is the most basic requirement for building up a successful management audit programme both for small as well as a large organisation. Thus, a comprehensive statement of policy provides definite understanding to management concerning the nature of audit to be performed and the scope and details of audit work to be carried out. This then will become the charter under which the management auditor should operate. In this charter, will be set forth, for the rest of the company to see, how executive management regards the purpose, mission and authority of the function of management auditor within the company. The statement must afford the auditor all the authority he needs yet does not assign responsibility which he cannot conceivably carry out. The statement must categorically say that the management auditor is capable of reviewing administrative and management controls over any activity within the company. However, he should not be expected to extend his activities to the evaluation of performance of professional and technical activities calling for specialised knowledge and skills and suggest remedies unaided by people competent to undertake such evaluation.

Location of audit function within the organisation - Some organisations depending upon their size and nature of have established a separate department of audit specialists where the head of the department reports directly to the top executive. In certain cases, the audit group may be a part of the activities of management services department, administrative control department or some other unit of organisation. The more important question, however, is that the function should be as entirely independent as possible of pressure from various groups in

the enterprise. The greater the independence, greater is the freedom to work effectively. Therefore, it is better to place the auditing function quite high in the organisation. The minimum requirement for the auditing organisation is to report to an officer whose status is such that he can command prompt and proper consideration of the auditor's opinion and recommendations. Preferably that officer should be a member of the Board. One of the controversies that is usually raised is whether the management auditor should report to the finance director, to whom he may be administratively responsible or to the managing director where he has no administrative responsibility. A third opinion would like the auditor to report to an audit committee, comprising of senior executives of the company who are preferably Board members. A different school of thought would like auditors to report to both the finance director and the audit committee. Though the controversy rages and no definite solution can be arrived at, it is felt that the controversy regarding which of these persons the management auditor should report to is not much substance where independence exists. Independence of the management auditor is not necessarily related to the person/persons he reports. His independence is entirely dependent on the management's attitude towards audit, the credibility the management auditor has with the management and the management's positive will to listen to criticism for self betterment.

Allocation of personnel - Whatever be the size of the enterprise, it is important that all persons selected and assigned to audit possess a good understanding of auditing theory, a thorough knowledge of the fundamentals of both organisation and management, the principles and effective methods of control, and the requirements for conducting scientific appraisal. "General Guidelines on Internal Auditing" issued by the Institute also emphasise these qualifications for an auditor whose area extends beyond the review of financial controls. As the management auditor is expected to evaluate operational performance and non-monetary operational controls, he should possess basic knowledge of the technology and commercial practices of the enterprise, an enquiring, analytical, pragmatic and imaginative approach and a thorough understanding of the control system. The management auditor should also have a basic knowledge of commerce, law, taxation, cost accounting, economics, quantitative methods and EDP systems. Knowledge in these areas would be adequate for him to identify problems and to determine steps to be taken when a problem is identified. It does not mean that management audit should be assigned to engineers, computer experts and others. Rather persons having sound accounting background alongwith general knowledge of other relevant disciplines are best suited to perform this job. Because the profession of accountancy basically teaches a systematic and analytical approach to a problem, it is this methodical approach which is the guiding note to an audit function of review of controls. In personal characteristics individuals assigned to the job should have an inclination towards analysis, a high degree of imagination and an ability to write and express themselves clearly and logically.

Staff training programme - A continuous training programme is necessary to achieve quality in performing audit assignments because the management auditor must keep a breast of new ways to improve auditing standards. An effective training programme enables staff to assume additional responsibilities and advancements in the organisation. Thus the programme acts as an incentive for drawing capable people into the department and keeping them.

Time and other aspects - The time required to carry out a management audit will vary, depending upon the extent and nature of assignment. For example, the time required to perform an audit of the entire activities of an organisation's purchasing department might take a few weeks, while an audit of the entire business could take several months. Much depends upon the size of the activity. An appraisal of a plant's standard cost system might also simultaneously include an appraisal of the departmental budgetary control system. In a study of the results of sales contacts and selling efforts in the field, one might find it feasible to study the expense reports and other costs incurred in making contacts. In the evaluation of the method of scheduling production in a plant, one might well take a good look at the sales department's method of compiling and preparing the sales forecast. The time and cost will vary for each assignment, depending upon the nature of the assignment, the number of auditors assigned to perform the work, and whether or not more specialists in a particular field are required. An audit of a production planning and control department, for example because of its size and other factors, could require an audit staff of several persons and, in addition, a specialist in production planning and one in production control. If an assignment is one which requires technical assistance of a nature unavailable within the audit group, it might be advisable to seek a qualified outside consultant to perform the work.

Frequency - Having specified various approaches to management audit, including its scope and its staffing requirements the last item that should be considered before undertaking such an audit is its frequency. Prime consideration should be given to the nature of the organisation. Is the company in a fast-changing industry where there is great accent on the latest technology in the company's products and/or services? When the organisation is subject to rapid change or the total resources utilised are expensive, the frequency of management auditing should be greater than when it does not undergo rapid changes or the resources employed are not high in value. In essence, management audits should be made often enough to provide protection against growing problems. On the other hand, they should not be so frequent as to lead to repetitious results of questionable value.

To get an idea of the optimum frequency of such an audit, it might be worthwhile to look at financial audits. Customarily, financial audits are conducted annually. They are highly programmed, since an internal control questionnaire is utilised to attest to accounting methods and procedures. By contrast, a management audit should be considered from a longer time frame. For an organisation, that is subject to rapid changes or consumes a great amount of high-cost resources, a two-years basis might be adequate to protect it from managerial and operational problems becoming entrenched or too large. For those organisations in a relatively stable industry, the frequency of audit can be every three years. In no case should the interval be allowed to exceed three years.

Question 7

What are the major differences between Financial and Operational Auditing?

Answer

Differences between Financial and Operational Auditing - The major differences between financial and operational auditing can be described as follows:

(i) **Purpose -** The financial auditing is basically concerned with the opinion that whether the historical information recorded is correct or not, whereas the operational auditing emphasizes on effectiveness and efficiency of operations for future performance.

(ii) **Area -** Financial audits are restricted to the matters directly affecting the appropriateness of the presented financial statements but the operational auditing covers all the activities that are related to efficiency and effectiveness of operations directed towards accomplishment of objectives of organization.

(iii) **Reporting -**The financial audit report is sent to all stock holders, bankers and other persons having stake in the Organisation. However the operational audit report is primarily for the management.

(iv) **End Task -** The financial audit has reporting the findings to the persons getting the report as its end objective, however, the operational auditing is not limited to reporting only but includes suggestions for improvement also

The main objective of operational auditing is to verify the fulfillment of plans, and sound business requirements. Operational auditing is considered as specialized management information tool. Operational auditing is essentially a function of internal auditing staff. Operational auditing is a systematic process of evaluating an organisation's effectiveness, efficiency and economy of operations under management control and reporting to appropriate persons, the result of the evaluation along with recommendations for improvements. Operational audit concentrates on effectiveness, efficiency and economy of operations and therefore it is future oriented. It does not end with the reporting of the findings but also recommends the steps for improvements in future. Operational auditing is not different from internal auditing; it is merely an extension of internal auditing into operational areas.

While in financial auditing, the concentration is more in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are minimized or removed. In financial auditing, an auditor is called upon to review the financial statements of an enterprise to ascertain whether they reflect true and fair view of its state of affairs and of its working results. He may analyse the operations of an enterprise to appraise their cost effectiveness and also he may seek evidence to review the managerial performances.

Question 8

State the important aspects to be considered by the External auditor in the evaluation of Internal Audit Function.

Answer

Evaluation of Internal Audit functions by external auditor: 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:

(a) **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 his 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.

(b) **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.

(c) **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.

(d) **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.

Question 9

You are appointed statutory auditor of X Ltd. X Ltd. has an internal audit system and reports for the same are given to you. Mention the factors you will consider to ensure that the said system of internal audit of X Ltd. is commensurate with the size of the company and nature of its business.

Answer

Internal Audit: As per Section 138 of the Companies Act, 2013, this clause has mandatory application in case of–

(a) every listed company;

(b) every unlisted public company having-

(i) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(ii) turnover of two hundred crore rupees or more during the preceding financial year; or

(iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(c) every private company having-

(i) turnover of two hundred crore rupees or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

The auditor has to examine whether the internal audit system is commensurate with the size of the company and the nature of its business.

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.

Question 10

Write a short note on - Summary Written Report.

Answer

Summary written reports: These are known as flash reports. They are significant highlights for immediate attention of top management. Generally suspected defalcations are reported briefly to the appropriate management official on the 'flash' basis, often ending up in referral for criminal investigation and legal action. It is common practice in number of companies of issuing a report quite frequently summarising the various individual reports issued and describing the range of their contents in a very brief and comprehensive manner where only important points are highlighted. Such reports are primarily issued for audit committees of Board of Directors and for other top level managers who do not have sufficient time to go through the elaborate reports and matters which are required to be brought to their notice for immediate action.

Question 11

XYZ, a manufacturing unit does not accept the recommendations for improvements made by the Operational Auditor. Suggest an alternative way to tackle the hostile management.

Answer

Alternative way to tackle the hostile management: 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 discuses 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 XYZ manufacturing unit should adopt above mentioned participative approach to tackle the hostile management of XYZ.

Question 12

Write short note on general objectives of an operational audit.

Answer

General objectives of operational audit: It includes-

(i) Appraisal of Controls.

(ii) Evaluation of performance.

(iii) Appraisal of objectives and plans and

(iv) Appraisal of organizational structure.

(i) **Appraisal of controls:** Operations and the results in which management is interested are largely a matter of control. If controls are effective in design and are faithfully adhered to the result that can be attained then they will be subject to the other limiting constraints in the organization.

(ii) **Evaluation of performance**: In the task of performance evaluation, an operational auditor is heavily dependent upon availability of acceptable standards. The operational auditor cannot be expected to possess technical background in so many diverse

technical fields obtaining even in one enterprise. Even when examining or appraising performance or reports of performance the operational auditor's mind is invariably fixed on control aspects.

(iii) **Appraisal of objectives and plans**: In performance appraisal, the operational auditor is basically concerned not so much with how well technically the operations are going on, but with accumulating information and evidence to measure the effectiveness, efficiency and economy with which the operations are being carried on.

(iv) **Appraisal of organisational structure**: Organisational structure provides the line of relationships and delegation of authority and tasks. This is an important element of the internal control design. In evaluating organisational structure, the operational auditor should consider whether the structure is in conformity with the management objectives and it is drawn up on the basis of matching of responsibility and authority. He should also analyse whether line of responsibility has been fixed, whether delegation of responsibility or authority is clear and there is no overlapping area.

Question 13

The Managing Director of X Ltd is concerned about high employee attrition rate in his company. As the internal auditor of the company he requests you to analyze the causes for the same. What factors would you consider in such analysis?

Answer

The factors responsible for high employee attrition rate are as under:

(i) Job Stress & work life imbalance

(ii) Wrong policies of the Management

(iii) Unbearable behaviour of Senior Staff

(iv) Safety factors

(v) Limited opportunities for promotion

(vi) Low monetary benefits

(vii) Lack of labour welfare schemes

(viii) Whether the organization has properly qualified and experienced personnel for the various levels of works?

(ix) Is the number of people employed at various work centres excessive or inadequate?

(x) Does the organization provide facilities for staff training so that employees and workers keep themselves abreast of current techniques and practices?

Question 14

Mr. 'P' have been appointed as operational auditor of M/s Books & Magazine Ltd. and observed a totaling error in invoice of ₹ 1,000. He has not taken care of the same saying that this is out of scope of his work. Comment.

Answer

Scope of Operational Audit: Operational auditing is a systematic process involving logical, structured and organized series of procedures. It concentrates on effectiveness, efficiency and economy of operations and therefore it is future oriented. It does not end with the reporting of the findings but also recommends the steps for improvement in future.

The main objective of operational auditing is to verify the fulfilment of plans and sound business requirements as also to focus on objectives and their achievement objectives; the operational auditor should not only have a proper business sense, he should also be equipped with a thorough knowledge of policies, procedures, systems and controls, he should be intimately familiar with the business, its nature and problems, and prospects and its environment. Above all, his mind should be open and active so as to be able to perceive problems and prospects, and grasp technical matters.

In carrying out his work probably at every step he will have to exercise judgement to evaluate evidence in connection with the situations and issues; he will have to get the assistance of norms and standards in every operating field to be able to objectively judge a situation. The norms and standards should be such as are generally acceptable or developed by the company itself.

To a traditional internal auditor, a loss of ₹ 1,000 caused by a wrong totaling of invoice is important and this is that he looks for. But for an auditor engaged in the review of operations, carrying out of a proper maintenance programme of the machines is of greater importance because considerable production loss due to machine breaks down can thus be prevented. In both the cases, the auditor's objective is to see that the business and its profitability do not suffer from avoidable loss, but, nevertheless, there is a distinct difference in approach. But it should not be assumed, that, since an operational auditor is concerned with the audit of operations and review of operating conditions, he is not concerned with the financial aspects of transaction and controls.

Hence, contention of operational auditor that totaling error in invoice of ₹ 1,000 is out of scope is not correct as operational audit is being carried out to ensure that all the management functions like planning, organizing, staffing, directing and controlling are working effectively and efficiently. Such kind of error is very much in scope because such an existence of error indicates that control system (controlling function) is not sound.

19

Internal Audit, Management and Operational Audit

Question 1

The Managing Director of X Ltd is concerned about high employee attrition rate in his company. As the internal auditor of the company he requests you to analyze the causes for the same. What factors would you consider in such analysis? (4 Marks, May, 2013)

Answer

The factors responsible for high employee attrition rate are as under:

(i) Job Stress & work life imbalance

(ii) Wrong policies of the Management

(iii) Unbearable behaviour of Senior Staff

(iv) Safety factors

(v) Limited opportunities for promotion

(vi) Low monetary benefits

(vii) Lack of labour welfare schemes

(viii) Whether the organization has properly qualified and experienced personnel for the various levels of works?

(ix) Is the number of people employed at various work centres excessive or inadequate?

(x) Does the organization provide facilities for staff training so that employees and workers keep themselves abreast of current techniques and practices?

Question 2

State the key differences between financial and operational audit. (4 Marks, May, 2012)

Or

What are the major differences between Financial and Operational Auditing? (8 Marks, May, 2008)

Answer

Differences between Financial and Operational Auditing - The major differences between financial and operational auditing can be described as follows:

(i) Purpose - The financial auditing is basically concerned with the opinion that whether the historical information recorded is correct or not, whereas the operational auditing emphasizes on effectiveness and efficiency of operations for future performance.

(ii) Area - Financial audits are restricted to the matters directly affecting the appropriateness of the presented financial statements but the operational auditing covers all the activities that are related to efficiency and effectiveness of operations directed towards accomplishment of objectives of organization.

(iii) Reporting -The financial audit report is sent to all stock holders, bankers and other persons having stake in the Organisation. However the operational audit report is primarily for the management.

(iv) End Task - The financial audit has reporting the findings to the persons getting the report as its end objective, however, the operational auditing is not limited to reporting only but includes suggestions for improvement also.

The main objective of operational auditing is to verify the fulfillment of plans, and sound business requirements. Operational auditing is considered as specialized management information tool. Operational auditing is essentially a function of internal auditing staff. Operational auditing is a systematic process of evaluating an organisation's effectiveness, efficiency and economy of operations under management control and reporting to appropriate persons, the result of the evaluation along with recommendations for improvements. Operational audit concentrates on effectiveness, efficiency and economy of operations and therefore it is future oriented. It does not end with the reporting of the findings but also recommends the steps for improvements in future. Operational auditing is not different from internal auditing; it is merely an extension of internal auditing into operational areas.

While in financial auditing, the concentration is more in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are minimized or removed. In financial auditing, an auditor is called upon to review the financial statements of an enterprise to ascertain whether they reflect true and fair view of its state of affairs and of its working results. He may analyse the operations of an enterprise to appraise their cost effectiveness and also he may seek evidence to review the managerial performances.

Question 3

Write short notes on General objectives of an operational audit. (4 Marks, May, 2011)

Or

Write short notes on Broad objectives of operational audit. (4 Marks, November, 2006)

Or

Briefly explain the objectives of Operational Audit. (5 Marks, November, 2005)

Answer

Objectives of operational audit: The scope and quality of operational auditing is predominantly dependent upon management attitudes. An open minded management with broad vision, can appreciate the need of operational auditing and to give it the necessary freedom and sanction to perform what it is capable of performing. Also, the qualities and the sense of perspectives of the operational auditor can mould operational audit in the right shape. Therefore, there is a possibility of operational auditing having different objectives to fulfil in different considerations. It include:

(i) Appraisal of Controls.

(ii) Evaluation of performance.

(iii) Appraisal of objectives and plans and

(iv) Appraisal of organizational structure.

(i) Appraisal of controls: Operations and the results in which management is interested are largely a matter of control. If controls are effective in design and are faithfully adhered to the result that can be attained then they will be subject to the other limiting constraints in the organization.

(ii) Evaluation of performance: In the task of performance evaluation, an operational auditor is heavily dependent upon availability of acceptable standards. The operational auditor cannot be expected to possess technical background in so many diverse technical fields obtaining even in one enterprise. Even when examining or appraising performance or reports of performance the operational auditor's mind is invariably fixed on control aspects.

(iii) Appraisal of objectives and plans: In performance appraisal, the operational auditor is basically concerned not so much with how well technically the operations are going on, but with accumulating information and evidence to measure the effectiveness, efficiency and economy with which the operations are being carried on.

(iv) Appraisal of organisational structure: Organisational structure provides the line of relationships and delegation of authority and tasks. This is an important element of the internal control design. In evaluating organisational structure, the operational auditor should consider whether the structure is in conformity with the management objectives and it is drawn up on the basis of matching of responsibility and authority. He should also analyse whether line of responsibility has been fixed, whether delegation of responsibility or authority is clear and there is no overlapping area.

Question 4

XYZ, a manufacturing unit does not accept the recommendations for improvements made by the Operational Auditor. Suggest an alternative way to tackle the hostile management.

(5 Marks, November, 2010)

Answer

Alternative way to tackle the hostile management: 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 discuses 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 XYZ manufacturing unit should adopt above mentioned participative approach to tackle the hostile management of XYZ.

Question 5

You are appointed statutory auditor of X Ltd. X Ltd. has a internal audit system and reports for the same are given to you. Mention the factors you will consider to ensure that the said system of internal audit of X Ltd. is commensurate with the size of the company and nature of its business. *(8 Marks, June, 2009)*

Or

As the Statutory Auditor of a Manufacturing Company, what are the points you will consider to conclude "Whether the company has an Internal Audit system commensurate with the size of the company and its operations"? *(8 Marks, November, 2007)*

Answer

Internal Audit: As per Section 138 of the Companies Act, 2013, it is mandatory to have internal audit in case of–

(a) every listed company;

(b) every unlisted public company having-

(i) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(ii) turnover of two hundred crore rupees or more during the preceding financial year; or

(iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(c) every private company having-

(i) turnover of two hundred crore rupees or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

The auditor has to examine whether the internal audit system is commensurate with the size of the company and the nature of its business.

The following are some of the factors to be considered in this regard:

(i) What is the size of the internal audit department? In considering the adequacy of internal audit staff, it is necessary to consider the nature of the business, the number of operating points, the extent to which control is decentralised, the effectiveness of other forms of internal control, etc.

(ii) What are the qualifications of the persons who undertake the internal audit work? Internal auditing is reasonable to expect that the internal audit department should normally be headed by a chartered accountant and that, depending upon the size of the department, it employs other qualified persons.

(iii) To whom does the internal auditor report? In general, the higher the level to which the internal auditor reports, the greater will be his independence.

(iv) What are the areas covered by the internal audit? Internal audit can cover a large number of areas including operational auditing, organisation and methods studies, special investigations and the like.

(v) Has the internal auditor adequate technical assistance? This can be provided either by having full-time technically qualified persons in the internal audit department or by such persons being deputed to the internal audit department for specific assignments.

(vi) What are the reports which are submitted by the internal auditor or what other evidence is there of his work? Auditor should satisfy himself that an internal audit system is functioning effectively. He can do so by examining the reports submitted by the internal auditor.

(vii) What is the follow-up? It is necessary that there is an adequate follow-up system to ensure that the errors pointed out are corrected and remedial action taken on the deficiencies reported upon.

Question 6

State the important aspects to be considered by the External auditor in the evaluation of Internal Audit Function. *(4 Marks, November, 2008)*

Or

Enumerate, in brief, the important aspects to be evaluated by the external auditor in determining the efficiency and extent of reliance to be placed on the work and function of an Internal Auditor. *(6 Marks, May, 2005)*

Answer

Evaluation of Internal Audit functions by external auditor: 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. As per SA 610 "Using the Work of Internal Auditors", factors that may affect the external auditor's determination of whether the work of the internal auditors is likely to be adequate for the purposes of the audit include:

(1) Objectivity

(i) The status of the internal audit function within the entity and the effect such status has on the ability of the internal auditors to be objective.

(ii) Whether the internal audit function reports to those charged with governance or an officer with appropriate authority, and whether the internal auditors have direct access to those charged with governance.

(iii) Whether the internal auditors are free of any conflicting responsibilities.

(iv) Whether those charged with governance oversee employment decisions related to the internal audit function.

(v) Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance.

(vi) Whether, and to what extent, management acts on the recommendations of the internal audit function, and how such action is evidenced.

(2) Technical competence

(i) Whether the internal auditors are members of relevant professional bodies.

(ii) Whether the internal auditors have adequate technical training and proficiency as internal auditors.

(iii) Compliance with the mandatory/ recommendatory Standards on Internal Audit (SIAs) issued by Internal Audit Standards Board of the Institute of Chartered Accountants of India (ICAI).

(iv) Whether there are established policies for hiring and training internal auditors.

(3) Due professional care

(i) Whether activities of the internal audit function are properly planned, supervised, reviewed and documented.

(ii) The existence and adequacy of audit manuals or other similar documents, work programs and internal audit documentation.

(4) Communication: Communication between the external auditor and the internal auditors may be most effective when the internal auditors are free to communicate openly with the external auditors, and:

(i) Meetings are held at appropriate intervals throughout the period;

(ii) The external auditor is advised of and has access to relevant internal audit reports and is informed of any significant matters that come to the attention of the internal auditors when such matters may affect the work of the external auditor; and

(iii) The external auditor informs the internal auditors of any significant matters that may affect the internal audit function.

The degree of reliance that a statutory auditor can place on the work done by the internal auditor is also a matter of individual judgement in a given set of circumstances. The ultimate responsibility for reporting on the financial statements is that of the statutory auditor. It must be clearly understood that the statutory auditor's responsibility is absolute and any reliance he places upon the internal audit system is part of his audit approach or technique and does not reduce his sole responsibility.

Question 7

K Ltd., requires you to organize a Management audit program. Briefly state a plan of action. *(8 Marks, May, 2007)*

Answer

Organizing a Management Audit for K Ltd.: The key requirement for a successful Management audit program would be the approval and support of the top management to initiate. Accordingly the following shall be the matters that should be considered while organizing the Management Audit of K. Ltd.

(i) **Devising a statement of policy:** In consultation with the top Management, a policy statement on Management should be issued. The policy should ideally cover the scope, objective, the authority of the management audit function. In short the policy should be drafted to become a charter of Management Audit.

(ii) **Location of audit function within the organization:** The hierarchical status of the Management auditor and his team should be clearly defined.

(iii) **Allocation of personnel:** The Management audit team should comprise of personnel who have adequate experience on all the facets of the organization, Ideally it should comprise of technical audit team.

(iv) **Staff Training:** In order to maintain qualitative standards, adequate and continuous training should be offered to the Management audit team.

(v) **Time and other aspects:** While planning management audit adequate consideration should be given to time & cost involved in conducting the audit.

(vi) **Frequency of audit:** Depending on the pace of change that happens in that industry, the frequency of the Management audit should be determined. This can be fixed in consultation with the top Management.

Question 8

You have been appointed Management Auditor of a large manufacturing company suffering from working capital crunch. Enlist and discuss the related areas which you would probe into to overcome the company's problem. *(8 Marks, November, 2004)*

Answer

Action plan to overcome working capital crunch: Adequate working capital is required for liquidity and smooth operations of the company. To ensure an adequate flow of working capital to the manufacturing company, the following action plan may be considered.

(i) **Working Capital Estimation:** The company should start by preparing a statement of the projected working capital requirements. This should be based on the functional budgets in sales, production, expenses, capital expenditure and the Master Budget consisting of projected profit and loss and the Balance Sheet.

(ii) **Cash Flow Statement / Cash Budget:** Month-wise cash budgets showing inflows and outflows of cash heading-wise should be prepared to analyse the major inflows and outflows affecting the entity. At this stage any wasteful outflow can be traced and eliminated. Bank reconciliation should be undertaken periodically so that outstandings can be traced and acted upon. This is also necessary to reduce the float time.

(iii) **Inventory / Stock Management:** Raw materials and inventories should be classified properly to determine the level of stock of materials. The method of costing also needs to be looked at minutely. There is a need to establish linkage with the production pattern and work backwards accounting for time factor in receipt of material. This needs to be worked out carefully since at no cost, production schedule should be hampered. The caution also need to be exercised that there is not unused/obsolete inventory. The system of inventory management needs to be looked at so as to check the avoidable wastes/scraps generated during storage and handling. Just in time philosophy will enable the company to reduce processing time, stocks and related costs. The adoption of such a mechanism would bring down the cost to a considerable extent.

(iv) **Credit Management:** The company should lay down a proper policy for evaluating customers, determining the credit period and offering discounts for early payment. An age-wise analysis of debtors should also be prepared so as to avoid credit to defaulters. The sale department need to be geared up so that realisation can be made in time. A careful analysis should be done of various customers according to pattern of sales so as to exercise control on their respective debit balances. The company should through its

purchase department endeavour to avail the maximum credit period from its creditors. This would enhance the working capital of the company.

(v) **Funds Flow Analysis:** The company should prepare a funds flow analysis, distinguishing between long-term and short-term sources and applications.

(vi) **Investment Management:** The idle funds of the company, if any, should be invested in short-term securities to augment the income.

(vii) **WIP Analysis:** Minimum WIP should be monitored and for the purpose it is necessary to ensure that no bottlenecks develop at any stage during the production process.

Question 9

Explain in brief the behavioural aspects encountered in the management audit and state the ways to solve them. *(8 Marks, May, 2004)*

Answer

Behavioural aspects encountered in Management Audit: Financial auditors deal mainly with figures. Management auditors deal mainly with people. There are many causes for behavioural problems arising in the review function of management audit. Particularly, when management auditors performs comprehensive audit of operations, they cannot be as well informed about such operations as a financial auditor in a financial department. Operating processes may be unfamiliar and complex. The operating people may be speaking a language and using terms that are foreign to the auditor's experience. The nature and causes of behavioural problems that the management auditor is likely to face in the discharge of the review function that is expected of him and possible solutions to overcome these problems are discussed below:

(1) **Staff / Line conflict**: Management auditors are staff people while the members of other departments are line people. Management auditors tend to discount the difficulties the line staff may face, if called on to act on the ideas of management auditors. Management auditors are specialists in their field and they may think their approach and solutions are the only answers.

(2) **Control**: The management auditor is expected to evaluate the effectiveness of controls, there is an instinctive reaction from the auditee that the report of the auditor may affect them. There is a fear that the action taken based on the management audit report will affect the line people. It breeds antagonism. The causes are under:

(i) Fear of criticism stemming from adverse audit findings.

(ii) Fear of change in day to day working habits because of changes resulting from audit recommendations.

(iii) Punitive action by superior prompted by reported deficiencies.

(iv) Insensitive audit practices.

(v) Hostile audit style.

Solution to behavioural problems: The following steps may be taken to overcome the aforesaid problems:

(i) To demonstrate that audit is part of an overall programme of review for protective and constructive benefit.

(ii) To demonstrate the objective of review is to provide maximum service in all feasible managerial dimensions.

(iii) To demonstrate the review will be with minimum interference with regular operation.

(iv) The responsible officers will be involved in the process of review of the findings and recommendations before the audit report is formally released.

It is essential to create an atmosphere of trust and friendliness so that audit reports will be understood in their proper perspective.

Finally, it needs hardly any emphasis that there should be right management culture, enlightened auditees and auditors of the right calibre. May be to expect a combination at all times of all the three is asking for the impossible. But, a concerted effort by the management, auditors and auditees to achieve a more acceptable climate would go a long way to achieve the goal.

20

Investigation and Due Diligence

Question 1

Sri Raghav is above 80 years old and wishes to sell his proprietary business of manufacture of specialty chemicals. C Ltd. wants to buy the business and appoints you to carry out a due diligence audit to decide whether it would be worthwhile to acquire the business.

What procedures you would adopt before you could render any advice to C Ltd.?

Answer

A due diligence audit on behalf of C Ltd. with a view to acquiring the business shall involve following steps:

(a) Brief history of the target and background of its promoters - The accountant should begin the financial due diligence review by looking into the history of the company and the background of the promoters. The details of how the company was set up and who were the original promoters have to be gone into, before verification of financial data in detail. An eye into the history of the target may reveal its turning points, survival strategies adopted by the target from time to time, the market share enjoyed by the target and changes therein, product life cycle and adequacy of resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the target. Broadly, the accountant should make relevant enquiries about the history of target's business products, markets, suppliers, expenses, operations

(b) Accounting policies - The accountant should study the accounting policies being followed by the target and ascertain whether any accounting policy is inappropriate. The accountant should also see the effects of the recent changes in the accounting policies. The target might have changed its accounting policies in the recent past keeping in view its intention of offering itself for sale. The overall scope has to be based on the accounting policies adopted by the management. The accountant has to look at the main effect of accounting policies on the overall profitability and their correctness. It is reiterated that the accountant should mainly look at all material changes in Accounting Policies in the period subjected to review very carefully.

The accountant's report should include a summary of significant accounting policies used by the target, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the target are different from those adopted by the acquiring enterprise, the effect of such differences.

(c) Review of Financial Statements - Before commencing the review of each of the aspect covered by the financial statements, the accountant should examine whether the financial statements of the target have been prepared in accordance with the Statute governing the target, Framework for Preparation and Presentation of the Financial Statements and the relevant Accounting Standards. If not the accountant should record the deviations from the above and consider whether it warrant an inclusion in the final report on due diligence.

After having an overall view of the financial statements, as mentioned in the above paragraphs, the accountant should review the operating results of the target in great detail. It is important to make an evaluation of the profit reported by the target. The reason being the price of the target would be largely based upon its operating results. The accountant should consider the presence of an extraordinary item of income or expense that might have affected the operating results of the target. It is advisable to compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period.

(d) Taxation - Tax due diligence is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. It is important to check if the company is regular in paying various taxes to the Government. Generally taxes are levied both by the Central Government as well as by the State Government. Further taxes may be direct or indirect. Most of the tax laws require the enterprise to register itself with the government and it is important to check if all necessary registrations have been made. The accountant has to also look at the tax effects of the merger or acquisition.

(e) Cash Flow - A review of historical cash flows and their pattern would reflect the cash generating abilities of the target company and should highlight the major trends. It is important to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time. It is necessary to check if a) Is the company able to honour its commitments to its trade payables, to the banks, to government and other stakeholders b) How well is the company able to turn its trade receivables and inventories c) How well does it deploy its funds d) Are there any funds lying idle or is the company able to reap maximum benefits out of the available funds?

(f) Financial Projections - The accountant should obtain from the target company the projections for the next five years with detailed assumptions and workings. He should ask to give projections on optimistic, pessimistic and most likely bases.

Ordinarily, it would be desirable that the accountant evaluates the appropriateness of assumption used in the preparation and presentation of financial projections. If, the accountant is of the opinion that as assumption used by the target is unrealistic, the accountant should consider its impact on the overall valuation of the company. He should offer his comments on all the assumption, highlighting those which, in his opinion are not inappropriate. In case he feels the projections provided by the target are not achievable or aggressive he has to mention this in his report. He should thoroughly check the arithmetic of the calculations made for financial projections.

(g) Management and Employees - In the Indian context, the status of work force, staff and employees and their demands is a complex problem. In most of the companies which are available for take over the problem of excess work force is often witnessed. It is important to work out how much of the labour force has to be retained. It is also important to judge the job profile of the administrative and managerial staff to gauge which of these match the requirements of the new incumbents. Due to complex set of labour laws applicable to them, companies often have to face protracted litigation from its workforce and it is important to gauge the likely impact of such litigation.

It is important to see if all employee benefits like Provident Fund (P.F.), Employees State Insurance (E.S.I), Gratuity, leave and Superannuation have been properly paid/ provided for/funded. In case of un-funded Gratuity, an actuarial valuation of the liability has to be obtained from a reputed actuary. The assumptions regarding increase in salaries, interest rate, retirement etc. have to be gone into to see if they are reasonable. It is also necessary to see if the basic salary /wage considered for the valuation is correct and includes all elements subject to payment of Gratuity. In the case of PF, ESI etc. the accountant has to see if all eligible employees have been covered.

It is very important to consider the pay packages of the key employees as this can be a crucial factor in future costs. One has to carefully look at Employees Stock Option Plans; deferred compensation plans; Economic Value Addition and other performance linked pay; sales incentives that have been promised etc. It is also important to identify the key employees who will not continue after the acquisition either because they are not willing to continue or because they are to be transferred to another company within the 'group' of the target company.

(h) Statutory Compliance - During a due diligence this is one aspect that has to be investigated in detail. It is important therefore, to make a list of laws that are applicable to the entity as well as to make a checklist of compliance required from the company under those laws. If the company has not been regular in its legal compliance it could lead to punitive charges under the law. These may have to be quantified and factored into the financial results of the company.

In addition to the above steps, the following further points have to be seen:

(i) Reason for sale of business and the effect on turnover and profits due to the exist of the present proprietor.

(ii) The length of the lease under which business has been operating.

(iii) The unexpired period of patents if any held by the vendors.

(iv) The age of managerial staff and prospects of their continuing in service in the new environment; the effect of trained managerial staff learning the organisation in production/sales/administrative and the financial liability to pay terminal benefits/ compensation, etc.

(v) If bulk sales are to a few limited customers, the profitability should be discounted greatly, because any substantial withdrawal of customers might cause business crashes.

(vi) A company with a sound financial structure can better withstand the stresses and strains of business. A low debt-equity ratio would indicate an ability to grow through debt financing without raising equity.

(vii) The cash generated from operations; the need for redeployment of resources and funds needed for repayment of loans become major factors in determining growth potential.

(viii) The valuation of goodwill if any should be on reasonable basis having regards to all factors mentioned above.

Question 2

An American Company engaged in the business of manufacturing and distribution of industrial gases, is interested in acquiring a listed Indian Company having a market share of more than 65% of the industrial gas business in India, request you to conduct a "Due Diligence" of this Indian Company and submit your Report. As due Diligence Auditor, what key areas you will cover in your review? List out the contents of your Due Diligence Review Report that you will submit to your USA based Client.

Answer

Due Diligence – Key Areas: The American company engaged in the business of manufacturing and distribution of industrial gases wishing to acquire a listed Indian company has commissioned the Due Diligence Audit to assess the strengths and weaknesses of this company. It is quite important for the acquirer to assess the proposal from different angles and specifically as per terms of the assignment and also see whether proposed merger would create operational synergies. On the other hand, financial due diligence review would be performed after the commercial valuation. Accordingly, while a preliminary review might be performed during initial stages of the restructuring exercise and may in fact, be performed simultaneously with the commercial evaluation, at a later stage, financial due diligence may be performed on the books of account and other information directly pertaining to the financial matters of the entity. In addition, a legal due diligence may be required where legal aspects of functioning of the entities are reviewed; for example, the legal aspects of property owned by the entity or compliance with various statutory requirements under various laws. Like other due diligence exercises, environmental and personnel due diligence are also carried out in order to establish whether various propositions with regard to environment and personnel of the enterprise under review are appropriate. In any case, it is quite important to look behind the veil of initial information provided by the company and to assess the benefits and costs of the proposed acquisition/merger by inquiring into all relevant aspects of the past, present and future of the business to be acquired. Some of the significant key areas which shall be covered under the review are as under:

(1) Historical Background: The accountant should begin the financial due diligence review by looking into the history of the company and the background of the promoters. The details of how the company was set up and who were the original promoters have to be gone into, before verification of financial data in detail. An eye into the history of the company may reveal its turning points, survival strategies adopted from time to time, the market share enjoyed by and changes therein, product life cycle and adequacy of

resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the said company. This could, inter alia, include the nature of business(es), location of production facilities, warehouses, offices, products or services and markets.

(2) **Significant Accounting Policies:** The accounting policies being followed by the company and the appropriateness thereof is another key area. The impact of the recent changes in the accounting policies in the recent past keeping in view its intention of offering itself for sale. The accountant has to look at the main effect of accounting policies on the overall profitability and their correctness. It is also quite important to ascertain significant accounting policies used by the company, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the company are different from those adopted by the acquiring enterprise and the effect of such differences. Finally, examine whether the financial statements of the company have been prepared in accordance with the governing statutory requirements.

(3) **Review of Financial Statements:** An evaluation of the profit reported by the company would be largely based upon its operating results. Any extraordinary item of income or expense that might have affected the operating results would require close examination. It is advisable to compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period. It is important that the trading results for the past four to five years are compared and the trend of normal operating profit arrived at. The normal operating profits should further be benchmarked against other similar companies. Besides the above, and based on the trend of operating results, the accountant has to advise the acquiring enterprise, through due diligence report, on the indicative valuation of the business. The exercise to evaluate the balance sheet of the company has to take into consideration the basis upon which assets have been valued and liabilities have been recognised. The net worth of the business has to be arrived at by taking into account the impact of over/under valuation of assets and liabilities.

(4) **Cash Flow:** A review of historical cash flows and their pattern would reflect the cash generating abilities of the company and should highlight the major trends. It is important to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time. It is necessary to check:

(a) Whether the company is able to honour its commitments to its trade payables, to the banks, to government and other stakeholders;

(b) How well is the company able to turn its trade receivables and inventories;

(c) How well does it deploy its funds; and

(d) Whether any funds are lying idle or is the company able to reap maximum benefits out of the available funds.

(5) **Financial Projections:** The projections for the next five years with detailed assumptions and workings and the appropriateness of assumption used in the preparation and presentation of financial projections. If the accountant is of the opinion that as assumption used by the company are unrealistic, the accountant should consider its impact on the overall valuation of the company.

(6) **Human Resources:** In the Indian context, the status of work force, staff and employees is a complex problem. It is important to work out how much of the labour force has to be retained. It is also important to judge the job profile of the administrative and managerial staff to gauge which of these match the requirements of the new incumbents. The aspects whether all employee benefits like PF, Gratuity, ESI and superannuation have been properly paid/funded. The pay packages of the key employees will be thoroughly reviewed since this can be a crucial factor in future employee costs.

(7) **Statutory Compliance:** This is one area that has to be examined in detail. It is important to make a list of laws that are applicable to the entity as well as to make a checklist of compliance required from the company under those laws. If the company has not been regular in its legal compliance, it could lead to punitive charges under the law. The impact on such violations be quantified and assessed in respect of entity; financial status and even on its governing concern status.

Contents of a Due Diligence Report: Briefly, the contents of a due diligence report can be discussed under:

- Terms of reference and scope of verification.
- Objective of due diligence.
- Brief history of the company including shareholding pattern.
- Assessment of management structure.
- Assessment of financial liabilities with special emphasis on Interlocking investments and financial obligations with group/associates companies, amounts receivables subject to litigation, any other likely liability which is not provided for in the books of account.
- Assessment of valuation of assets including comments on properties, terms of leases, lien and encumbrances including status of charges, liens, mortgages, assets and properties of the company.
- Assessment of operating results.
- Assessment of taxation and statutory liabilities.
- Assessment of possible liabilities on account of litigation and legal proceedings against the company and suggestion on ways and means including affidavits, indemnities, to be executed to cover unforeseen and undetected contingent liabilities.
- Assessment of net worth.
- Suggestions on various aspects to be taken care of before and after the proposed merger / acquisition.
- Status of franchises, license and patents.

Finally, an executive summary may be prepared highlighting the significant areas.

Question 3

A nationalised bank received an application from an export company seeking sanction of a term loan to expand the existing sea food processing plant. In this connection, the General Manager, who is in charge of Advances, approaches you to conduct a thorough investigation of this limited company and submit a confidential report based on which he will decide whether to sanction this loan or not.

List out the points you will cover in your investigation before submitting your report to the General Manager.

Answer

Investigation on Behalf of the Bank for Advances: A bank is primarily interested in knowing the purpose for which a loan is required, the sources from which it would be repaid and the security that would be available to it, if the borrower fails to pay back the loan. On these considerations, the investigating accountant, in the course of his enquiry, should attempt to collect information on the under mentioned points:

(i) The purpose for which the loan is required and the manner in which the borrower proposes to invest the amount of the loan.

(ii) The schedule of repayment of loan submitted by the borrower, particularly the assumptions made therein as regards amounts of profits that will be earned in cash and the amount of cash that would be available for the repayment of loan to confirm that they are reasonable and valid in the circumstances of the case. Institutional lenders now-a-days rely more for payment of loans on the reliability of annual profits and loss on the values of assets mortgaged to them.

(iii) The financial standing and reputation for business integrity enjoyed by directors and officers of the company.

(iv) Whether the company is authorised by the Memorandum or the Articles of Association to borrow money for the purpose for which the loan will be used.

(v) The history of growth and development of the company and its performance during the past 5 years.

(vi) How the economic position of the company would be affected by economic, political and social changes that are likely to take place during the period of loan.

To investigate the profitability of the business for judging the accuracy of the schedule of repayment furnished by the borrower, as well as the value of the security in the form of assets of the business already possessed and those which will be created out of the loan, the investigating accountant should take the under-mentioned steps:

(a) Prepare a condensed income statement from the Statement of Profit and Loss for the previous five years, showing separately therein various items of income and expenses, the amounts of gross and net profits earned and taxes paid annually during each of the five years. The amount of maintainable profits determined on the basis of foregoing statement should be increased by the amount by which these would increase on the investment of borrowed funds.

(b) Compute the under-mentioned ratios separately and then include them in the statement to show the trend as well as changes that have taken place in the financial position of the company:

(i) Sales to Average Inventories held.

(ii) Sales to Fixed Assets.

(iii) Equity to Fixed Assets.

(iv) Current Assets to Current Liabilities.

(v) Quick Assets (the current assets that are readily realisable) to Quick Liabilities.

(vi) Equity to Long Term Loans.

(vii) Sales to Book Debts.

(viii) Return on Capital Employed.

(c) Enter in a separate part of the statement the break-up of annual sales product-wise to show their trend.

Steps involved in the verification of assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank - The investigating accountant should prepare schedules of assets and liabilities of the borrower and include in the particulars stated below:

(a) Fixed assets - A full description of each item, its gross value, the rate at which depreciation has been charged and the total depreciation written off. In case the rate at which depreciation has been adjusted is inadequate, the fact should be stated. In case any asset is encumbered, the amount of the charge and its nature should be disclosed. In case an asset has been revalued recently, the amount by which the value of the asset has been decreased or increased on revaluation should be stated along with the date of revaluation. If considered necessary, he may also comment on the revaluation and its basis.

(b) Inventory - The value of different types of inventories held (raw materials, work-in-progress and finished goods) and the basis on which these have been valued.

Details as regards the nature and composition of finished goods should be disclosed. Slow-moving or obsolete items should be separately stated along with the amounts of allowances, if any, made in their valuation. For assessing redundancy, the changes that have occurred in important items of inventory subsequent to the date of the Balance Sheet, either due to conversion into finished goods or sale, should be considered.

If any inventory has been pledged as a security for a loan the amount of loan should be disclosed.

(c) Trade Receivables, including bills receivable - Their composition should be disclosed to indicate the nature of different types of debts that are outstanding for recovery; also

whether the debts were being collected within the period of credit as well as the fact whether any debts are considered bad or doubtful and the provision if any, that has been made against them.

Further, the total amount outstanding at the close of the period should be segregated as follows:

(i) debts due in respect of which the period of credit has not expired;

(ii) debts due within six months; and

(iii) debts due but not recovered for over six months.

If any debts are due from directors or other officers or employees of the company, the particulars thereof should be stated. Amounts due from subsidiary and affiliated concerns, as well as those considered abnormal should be disclosed. The recoveries out of various debts subsequent to the date of the Balance sheet should be stated.

(d) Investments - The schedule of investments should be prepared. It should disclose the - date of purchase, cost and the nominal and market value of each investment. If any investment is pledged as security for a loan, full particulars of the loan should be given.

(e) Secured Loans - Debentures and other loans should be included together in a separate schedule. Against the debentures and each secured loan, the amounts outstanding for payments along with due dates of payment should be shown. In case any debentures have been issued as a collateral security, the fact should be stated. Particulars of assets pledged or those on which a charge has been created for re-payment of a liability should be disclosed.

(f) Provision of Taxation - The previous years up to which taxes have been assessed should be ascertained. If provision for taxes not assessed appears in be inadequate, the fact should be stated along with the extent of the shortfall.

(g) Other Liabilities - It should be stated whether all the liabilities, actual and contingent, are correctly disclosed. Also, an analysis according to ages of trade payables should be given to show that the company has been meeting its obligations in time and has not been depending on trade credit for its working capital requirements.

(h) Insurance - A schedule of insurance policies giving details of risks covered, the date of payment of last premiums and their value should be attached as an annexure to the statements of assets, together with a report as to whether or not the insurance-cover appears to be adequate, having regard to the value of assets.

(i) Contingent Liabilities - By making direct enquiries from the borrower company, from members of its staff, perusal of the files of parties to whom any loan has been advanced those of machinery suppliers and the legal adviser, for example, the investigating accountant should ascertain particulars of any contingent liabilities which have not been disclosed. In case, there are any, these should be included in a schedule and attached to the report.

(j) The impact on economic position of the company by economic, political and social changes those are likely to take place during the period of loan.

Finally, the investigating accountant should ascertain whether any application for loan to another bank or any other party has been made. If so, the result thereof should be examined.

Question 4

What are the important steps involved while conducting Investigation on behalf of an Incoming Partner?

Answer

Steps involved while conducting investigation on behalf of an incoming partner: The general approach of the investigating accountant in this type of investigation would be more or less similar, irrespective of the nature of business of the firm-manufacturing, trading or rendering a service.

Primarily, an incoming partner would be interested to know whether the terms offered to him are reasonable having regard to the nature of the business, profit records, capital distribution, personal capability of the existing partners, socio-economic setting, etc., and whether he would be capable of deriving continuing benefit in the shape of return on capital to be contributed and remuneration for services to be rendered, which can be justified by the overall economic conditions prevailing and other considerations considering his own personality and achievements. In addition, he would be interested to ascertain whether the capital to be contributed by him would be safe and applied usefully.

Broadly, the steps involved are the following:

(a) Ascertainment of the history of the inception and growth of the firm.

(b) Study of the provisions of the deed of partnership, particularly for composition of partners, their capital contribution, drawing rights, retirement benefits, job allocation, financial management, goodwill, etc.

(c) Scrutiny of the record of profitability of the firm's business over a suitable number of years, with usual adjustments that are necessary in ascertaining the true record of business profits. Particular attention should, however, be paid to the nature of partners' remuneration, which may be excessive or inadequate in relation to the nature and profitability of the business, qualification and expertise of the partners and such other factors as may be relevant.

(d) Examination of the asset and liability position to determine the tangible asset backing for the partner's investment, appraisal of the value of intangibles like goodwill, know how, patents, etc. impending liabilities including contingent liabilities and those for pending tax assessment. In case of firms rendering services, the question of tangible asset backing usually is not important, provided the firm's profit record, business coverage and standing of the partners are of the acceptable order.

(e) Position of orders at hand and the range and quality of clientele should be thoroughly examined, which the firm is presently operating.

(f) Position and terms of loan finance would call for careful scrutiny to assess its usefulness and implication for the overall financial position; reason for its absence should be studied.

(g) It would be interesting to study the composition and quality of key personnel employed by the firm and any likelihood of their leaving the organisation in the near future.

(h) Various important contractual and legal obligations should be ascertained and their nature studied. It may be the case that the firm has standing agreement with the employees as regards salary and wages, bonus, gratuity and other incidental benefits. Full import of such standing agreements would be gauged before a final decision is reached.

(i) Reasons for the offer of admission to a new partner should be ascertained and it should be determined whether the same synchronises with the retirement of any senior partner whose association may have had considerable bearing on the firm's success.

(j) Appraisal of the record of capital employed and the rate of return. It is necessary to have a comparison with alternative business avenues for investments and evaluation of possible results on a changed capital and organisation structure, if any, envisaged along with the admission of the partner.

(k) It would be useful to have a first hand knowledge about the specialisation, if any, attained by the firm in any of its activities.

(l) Manner of computation of goodwill on admission as also on retirement, if any, should be ascertained.

(m) Whether any special clause exists in the deed of partnership to allow admission in future of a new partner, who may be specified, on concessional terms.

(n) Whether the incomplete contracts which will be transferred to the reconstituted firm will be a liability or a loss.

It would always be worthwhile to remember that, in a partnership, personal considerations count predominantly over other considerations and assessment of standing of the firm, standing and reliability of other partners, their personal reputation and the goodwill enjoyed by the products/services are important.

On the basis of the broad frame of considerations as given above, the investigating accountant should devise his own considerations in each case which may be quite diverse. Additional considerations may come up in the case of service-rendering firms where profit and business record, goodwill of the firm and of individual partners would assume greater significance.

Again, in the case of industrial firms, the network of customers, their scatter, size, etc., would be relevant for consideration.

Question 5

Write a short note on - Audit and Investigation.

Answer

As Per SA 200 "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with standards on auditing". The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

For auditing on the other hand, the general objective is to find out whether the financial statements show true and fair view. The auditor seeks to report what he finds in the normal course of examination of the accounts adopting generally followed techniques unless circumstances call for a special probe. As per sub section 12 of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure. Fraud, error, irregularity, whatever comes to the auditor's notice in the usual course of checking, are all looked into in depth and sometimes investigation results from the prima facie findings of the auditor.

Investigation implies systematic, critical and special examination of the records of a business for a specific purpose. The examination conducted under investigation is intensive as well as exhaustive so far as the activities or areas of accounting is concerned. Investigation requires a concentrated focus on the subject matter of inquiry and related matters. Often, investigations may spread over a period longer than one year and its scope may extend to inquiry beyond the books of accounts if the circumstances so require.

For example if fraud is suspected and an accountant is called upon to check the accounts to whether fraud really exists and if so, the amount involved, the character of the enquiry changes into investigation. Investigation may be undertaken in numerous areas of accounts, e.g., the extent of waste and loss, profitability, cost of production etc. It extends scope beyond books of accounts.

Etymologically, auditing and investigation are largely overlapping concepts because auditing is nothing but an investigation used in a broad sense. Both auditing and investigation are fact finding techniques but their basic nature and objectives differ as regards scope, frequency, basis, thrust, depth and conclusiveness. Audit and investigation differ in objectives and in their nature. Auditing is general while investigation is specific.

Basis of Difference	Investigation	Audit
(i) Objective	An investigation aims at establishing a fact or a happening or at assessing a particular situation.	The main objective of an audit is to verify whether the financial statements display a true and fair view of the state of affairs and the working results of an entity.
(ii) Scope	The scope of investigation may be governed by statute or it may be non- statutory.	The scope of audit is wide and in case of statutory audit the scope of work is determined by the provisions of relevant law.
(iii) Periodicity	The work is not limited by rigid time frame. It may cover several years, as the outcome of the same is not certain.	The audit is carried on either quarterly, half-yearly or yearly.
(iv) Nature	Requires a detailed study and examination of facts and figures.	Involves tests checking or sample technique to draw evidences for forming a judgement and expression of opinion.
(v) Inherent Limitations	No inherent limitation owing to its nature of engagement.	Audit suffers from inherent limitation.
(vi) Evidence	It seeks conclusive evidence.	Audit is mainly concerned with prima- facie evidence.
(vii) Observance of Accounting Principles	It is analytical in nature and requires a thorough mind capable of observing, collecting and evaluating facts.	Is governed by compliance with generally accepted accounting principles, audit procedures and disclosure requirements.
(viii) Reporting	The outcome is reported to the person(s) on whose behalf investigation is carried out.	The outcome is reported to the owners of the business entity.

Question 6

Mr. Clean who proposes to buy the proprietary business of Mr. Perfect, engages you as investigating accountant. Specify the areas which you will cover in your investigation.

Answer

Areas to be covered in investigation as an investigating accountant:

(a) Studying the overall picture: The first and foremost important aspect in any business investigation is to have an overall picture of the position of the business which is being investigated before the details are gone into. Further, it is important to know whether the business is engaged in the manufacture of one or two important lines of products, is principally processing materials or is concerned only with the sale of a single product. Also, whether it is a business which depends for its success on imported raw materials or supply of parts and components from ancillary businesses or uses indigenous materials and parts which are manufactured locally. If the business is labour - intensive, its future profitability would be dependent on availability of skilled labour and relations of the management with the trade unions. Labour relations thus can affect the future profitability of the business. The method of distribution of products, either through wholesalers or retailers also must be examined. For studying the economic and financial position of the business, the following should be considered:

(i) The adequacy or otherwise of fixed and working capital. Are these sufficient for the growth of the business?

(ii) What will be the trend of the sales and profits in the future? The success of a business in the future would depend on the position enjoyed by it in the past in relation to its competitors. A business may be successful because it enjoys a monopoly. In such a case, the possibility of emergence of competition must be examined. This may be ascertained on the basis of the trend in market share of the product and the licensing policy followed by the government. Establishing the trend of sales, product-wise and area-wise will ordinarily help in drawing a conclusion on whether the trend will be maintained in the future.

(iii) Whether the profit which the business could be expected to maintain in the future would yield an adequate return on the capital employed?

From the accountant's view point, the following specific areas need to be looked into:

(b) Statement of Profit and Loss: To study the Statement of Profit and Loss of a concern and consider each item included therein, in relation to the corresponding items in the Statement of Profit and Loss of the previous years. It is therefore, necessary that a summary, in a columnar form, should be prepared of the balances included in the Statement of Profit and Loss of the business for a period, say of 5 to 7 years. In the preparation of the summary attention should also be paid to the following matters:

Turnover - The figures of sales should be broken down between the various products sold to show variations in turnover of individual products from year to year. In this way, it would be possible to find out the products the sales of which have been increasing and those the sales of which have been falling. Further, by reference to the list of customers, in the Order Books, it should be ascertained whether the business has a very large turnover with a few customers or a small turnover with several customers. The Order Books should also be examined to find out if fictitious sales have been centered in any

year to boost up profits. If so, the figures of sales of the year or years should be adjusted. If the business consists of activities which are dissimilar in operation, like manufacturing and agency, then apart from splitting the income between the two sources, expenses should also be apportioned between them to separately arrive at the figures of profit from each of the activities.

Wage structure - The method of computing wages and the rates of wages should be examined. On occasions a business may have to pay higher wages than those prevailing in other business in the same neighbourhood in pursuance of an industrial award. Another factor which is important to consider in this connection is the relationship of the business with its workers. A business which has suffered several industrial disputes, strikes, etc. and has had its working interrupted by them frequently cannot be expected to prosper unless a proper settlement is reached with workers' unions.

Depreciation - The charge on account of depreciation and maintenance of machinery and other assets included in the accounts of different years should be compared to verify that depreciation has been provided from year to year on a consistent basis and that it is adequate. Also, the necessary adjustment in the depreciation charge should be made if it is the practice of the company to write off the assets on a renewal basis. Further, if assets have been revalued, it should be confirmed that depreciation on the increased valuation has been adjusted. In this respect it may be noted that Para 26 of AS-6 'Depreciation Accounting' states that in case of revaluation of depreciable assets, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful life of the assets. If the annual maintenance charge has been fluctuating from year to year, it may indicate that the plant or the building has not been regularly repaired. Generally, with age, the cost of maintenance of assets should increase. If it has not, the reason thereof should be ascertained. In case of leasehold property, it should be ascertained whether an adequate provision has been made for the dilapidation charge which may be payable at the end of the lease.

Managerial Remuneration - It should be verified that the remuneration payable to various members of managerial personnel is not excessive in relation to the profits of the business after taking into account the time devoted by each of them. However, it could also be that no or only a nominal remuneration has been charged in the accounts. In either case, an adjustment should be made to arrive at true profitability of the concern. Further, in case of company, requirement of relevant section of Companies Act, 2013 is to be seen. It has to be assured that calculation of profit for arriving at the remuneration is correct.

Exceptional and non-recurring items - It is customary to adjust exceptional items in the summary of Statement of Profit and Loss in order that they may not obscure the trend of the profits. In the matter of non-recurring items, it is necessary to remember that adjustments are to be made in respect of exceptional items which do not recur from year to year or can be considered exceptional having regard to their materiality or periodicity. In this connection, it is worthwhile to examine the income tax assessment orders of the business to find out the items which have been treated as revenue but have been regarded by the taxing authority as inadmissible. Where the effect of these has been abnormal on the tax paid by the company from year to year, suitable adjustments should be made in the figures of taxes paid, as well as in the assets amounts. Likewise, adjustments should be made in respect of exceptional profits and losses.

Repairs and maintenance - It is one of the recurring expenses of a business. Occasionally it is noticed that this expenditure is unduly heavy in some of the years, while quite low in some others. Generally, companies, as a matter of routine undertake major repairs, overhauls and maintenance programme at an interval of 3 or 4 years while running repairs and maintenance continue in the usual manner which gives rise to fluctuating charges in the accounts unless periodic major expenses are treated as deferred expenditure. Besides, due to wrong allocation of expenses between capital and revenue, repair charges may appear to be heavy or low. If fluctuating and abnormal charges for repairs is noticed, it would be the duty of the investigating accountant to scrutinise this head thoroughly to establish correct and normal charge for repairs.

Unusual year - A company's record of profitability may show a trend of increasing or decreasing profit or loss or it may be highly erratic and fluctuating. Where a definite trend is discernible, the job of the investigating accountant is somewhat simplified. He can adopt recent years' record of profitability as the basis for estimating future maintainable profit having regard to the inflationary state in the economy. But if the same is fluctuating, there would be more demand on judgement of the accountant in selecting the period to be covered for estimation of profitability. In such cases it may even be necessary to take into consideration results of past 9 to 10 years with a view to iron out the fluctuation. If, however, it is noticed that results of one or more years under scrutiny were materially vitiated by exceptional factors like a long term industrial dispute, natural calamities, fire, war, ravage etc., the investigating accountant should eliminate such year/years from consideration altogether since they do not reflect the results obtained through normal business.

(c) Balance Sheet -

Fixed Assets: Fixed assets, usually, are shown in accounts at cost less depreciation but the accounts do not show the ages of different assets. It is desirable, therefore, to obtain age analysis of various items of fixed assets. Assets which are old or are obsolete would naturally have to be replaced. It should be seen that their values are not in excess of the value of service that they could be expected to render to the business during the balance period of their active life and the amount they would fetch on sale as scrap.

Investments - Investments should be broadly classified into long term investments and current investments. A current investment is by its nature readily realisable and is intended to be held for not more than one year. All other investments are long term investments. Current investments are valued on the basis of lower of cost and fair value determined either on an individual investment basis or by category of investment but not on an overall basis. Long-term investments are usually carried at cost. However, when there is a permanent decline in the value of long-term investments, the carrying amount should be reduced to recognise the decline. The carrying amount of long term

investments is determined on an individual investment basis. Interest, dividends and rentals receivable in connection with investment are generally regarded as income. However in some cases, such receipts represent recovery of cost and should therefore be reduced from, the cost of investment (e.g. dividend out of pre-acquisition profits).

Inventories: It should be seen that inventories have been valued consistently and that the basis of valuation was such that the value placed on inventories did not include any element of profit. Also, there should be due allowance for damaged, obsolete and slow moving inventories.

Trade Receivables - In assessing their value, the following should be taken into account:

(i) Whether bad debts have been adjusted in the years in which the relevant sales took place instead of in the year in which they have been written off. Normally, such an adjustment should be made but not when debts have had to be written off on account of a slump or a fall in international prices, during a period subsequent to the period in which sales had taken place.

(ii) The length of the credit period allowed throughout the period under investigation, to determine whether it has been necessary to increase continually the credit period in order to effect the sales. If it has been so, it would indicate that the demand for the goods manufactured by the concern in the market has been diminishing gradually.

(iii) Debts should be classified according to their age. This would disclose the character of the parties with whom the company trades and the amount of working capital that will be necessarily blocked on this account in the course of business.

Other liquid assets: It should be ascertained that the assets so described are readily realisable. Money with a bank in liquidation should be taken only to the extent guaranteed by Deposit Insurance Scheme.

Idle assets: On a scrutiny, it may appear that certain assets are remaining idle and are not being properly applied in the business. For example, certain plant and machinery may have been put to use after a considerable period of time after acquisition. Some of the fixed assets may be awaiting installation even at the valuation time.

Liabilities: The important matter to investigate in this regard is whether those are stated fully or understated or overstated. In other words, whether the profits of the business have been inflated by suppression of liabilities or there are any free reserves included in the liabilities. In either case, an adjustment would be necessary. Secondly, it should be ascertained that liabilities are not unduly 'large or are not outstanding for a long time, in such cases, it would be necessary to pay off some of them which would cause a drain on the liquid resources of the concern. The fact should be stated in the report.

Taxation: Orders in respect of assessments completed should be studied and it should be verified that an adequate provision has been made in respect of liabilities for taxes which have not been assessed. Also, it should be seen that in the past there has been no reopening of assessments. If so, the company may be liable for an undisclosed sum of taxes plus penalties. Any temporary tax benefit should also be disregarded.

Capital - In this regard, it is necessary to ascertain:

(i) Whether the capital is well balanced. This would not be the case if the amount of debentures and preference share capital are disproportionately large as compared to the equity capital, for this would be a handicap to the company in raising further equity capital, on favourable terms for financing the business or to pay off capital commitment. Further, when the capital is highly geared, it would affect the value of the equity capital;

(ii) That the amount of capital is reasonable compared to the value of fixed assets and the amount of working capital required. The terms associated with the issue of the capital should also be studied; restriction on transferability of shares usually depresses the value of share and of the business.

(d) Interpretation of figures -

Fixed Assets - The amount of capital expenditure which would be necessary in the future for the continuation of the business, in its existing stage, should be assessed having regard to the under mentioned factors:

(i) the amount required for the replacement of assets when these would become worn out or obsolete;

(ii) the expenditure which will be necessary to replace obsolete machinery by more sophisticated machinery for manufacturing different types of goods for which there is demand.

Turnover - In assessing the turnover which the business would be able to maintain in the future, the following factors should be taken into account:

(i) Trend: Whether in the past sales have been increasing consistently or they have been fluctuating. A proper study of this phenomenon should be made.

(ii) Marketability: Is it possible to extend the sales into new markets or that these have been fully exploited? Product wise estimation should be made.

(iii) Political and economic considerations: Are the policies pursued by the Government likely to promote the extension of the market for goods to other countries? Whether the sales in the home market are likely to increase or decrease as a result of various emerging economic trends?

(iv) Competition: What is the likely effect on the business if other manufacturers enter the same field or if products which would sell in competition are placed on the market at cheaper price? Is the demand for competing products increasing? Is the company's share in the total trade constant or has it been fluctuating?

Working Capital - In making assessment of the working capital requirements in the future, the following matters should be taken into account:

(i) Has the ratio of inventory to turnover been increasing and if so, is it a continuing or only a temporary trend?

(ii) Are the trade payables being paid promptly or is there a backlog which will have to be dealt with?

(iii) What will be the effect on inventory, trade receivables and trade payables, if the turnover is increased or if new products are introduced?

Estimating future maintainable profits - Fluctuations in profits during the years under review should be examined after adjusting the profits for extraneous factors, if any, that had given rise to fluctuations to determine whether the factors responsible for the fluctuations were temporary or was likely to recur in future. A statement should be prepared showing separately the profits after depreciation earned in each of the years during the period under review, after making adjustments therein, if considered necessary, as regards factors which have been responsible for any extraordinary increase in profits. If the percentage of profits before taxation to capital has been stable or has been increasing, it would indicate that the business would continue to earn the same rate of profit as it has done in the past. If, on the other hand, the percentage has been falling, and there is no evidence that the factors responsible therefore have ceased to operate, investment of further capital in the business would not be commercially advisable.

Question 7

Your client is contemplating taking over a manufacturing concern and desires that in the course of due diligence review, you should look specifically for any hidden liabilities and overvalued assets.

State (in brief) the major areas you would examine for the above.

Answer

Major areas to examine in course of Due Diligence Review: 'Due Diligence' is a term that is often heard in the corporate world these days in relation to corporate restructuring. The purpose of due diligence is to assist the purchaser or the investor in finding out all he can, reasonably about the business he is acquiring or investing in prior to completion of the transaction including its critical success factors as well as its strength and weaknesses.

Due diligence is an all pervasive exercise to review all important aspects like financial, legal, commercial, etc. before taking any final decision in the matter. As far as any hidden liabilities or overvalued assets are concerned, this shall form part of such a review of Financial Statements. Normally, cases of hidden liabilities and overvalued assets are not apparent from books of accounts and financial statements. Review of financial statements does not involve examination from the view point of extraordinary items, analysis of significant deviations, etc.

However in order to investigate hidden liabilities the auditor should pay his attention to the following areas:

- The company may not show any show cause notices which have not matured into demands, as contingent liabilities. These may be material and important.
- The company may have given “Letters of Comfort” to banks and Financial Institutions. Since these are not “guarantees”, these may not be disclosed in the Balance sheet of the target company.
- The Company may have sold some subsidiaries/businesses and may have agreed to take over and indemnify all liabilities and contingent liabilities of the same prior to the date of transfer. These may not be reflected in the books of accounts of the company.
- Product and other liability claims; warranty liabilities; product returns/discounts; liquidated damages for late deliveries etc. and all litigation.
- Tax liabilities under direct and indirect taxes.
- Long pending sales tax assessments.
- Pending final assessments of customs duty where provisional assessment only has been completed.
- Agreement to buy back shares sold at a stated price.
- Future lease liabilities.
- Environmental problems/claims/third party claims.
- Unfunded gratuity/superannuation/leave salary liabilities; incorrect gratuity valuations.
- Huge labour claims under negotiation when the labour wage agreement has already expired.
- Contingent liabilities not shown in books.

Regularly Overvalued Assets:

The auditor shall have to specifically examine the following areas:

- Uncollected/uncollectable receivables.
- Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with name of company.
- Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.
- Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue.
- Litigated assets and property.
- Investments carried at cost though realizable value is much lower.
- Investments carrying a very low rate of income / return.
- Infructuous project expenditure/deferred revenue expenditure etc.
- Group Company balances under reconciliation etc.
- Intangibles of no value.

Question 8

A company engaged in manufacturing of chemicals is consistently recording higher sales turnover, but declining net profits since the last 5 years. As an investigator appointed to find out the reasons for the same, what are the points you would verify?

Answer

Decline in Net Profits despite Increasing Sales: 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 Statement of Profit and Loss 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.

Question 9

In a Company, it is suspected that there has been embezzlement in cash receipts. As an investigator, what are the areas that you would verify?

Answer

The following areas need to be verified in this regard:

(i) Issuing a receipt to the payee for the full amount collected and entering only a part of the amount on the counterfoil.

(ii) Showing a larger cash discount than actually allowed.

(iii) Adjusting a fictitious credit in the account of a customer for the value of goods returned by him.

(iv) Adjusting a cash sale as a credit sale, and raising a debit in the account of the customer.

(v) Writing off a good debt as bad and irrecoverable to cover up the amount collected which has been misappropriated.

(vi) Short-debiting the customer's account in the ledger with an intention to withdraw the difference when the full amount payable by him is collected.

(vii) Under-casting the receipts side of the Cash Book or over-casting the payment side; carrying over a shorter total of the receipts from one page of the Cash Book to the next or over-carrying the total of the payment from one page of the Cash Book to the next with a view to covering up misappropriation; either short banking of cash collection or apart of the amount withdrawal from the bank.

Question 10

What are the areas in which Due Diligence can take place?

Answer

Areas in which Due Diligence can take place -

1. **Commercial/operational due diligence**: It is generally performed by the concerned acquire enterprise involving an evaluation from commercial, strategic and operational perspectives. For example, whether proposed merger would create operational synergies.
2. **Financial Due Diligence**: It involves analysis of the books of accounts and other information pertaining to financial matters of the entity. It should be performed after completion of commercial due diligence.
3. **Tax Due diligence**: It is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence .The accountant has to look at the tax affect of the merger or acquisition.
4. **Information systems due diligence**: It pertains to all computer systems and related matter of the entity.
5. **Legal due diligence**: This may be required where legal aspects of functioning of the entity are reviewed. For example, the legal aspects of property owned by the entity or compliance with various statutory requirements under various laws.
6. **Environmental due diligence**: It is carried out in order to study the entity's environment, its flexibility and adaptiveness to the acquirer entity.

7. **Personnel due diligence**: It is carried out to ascertain that the entity's personnel policies are in line or can be changed to suit the requirements of the restructuring.

Question 11

Write short note on Frauds through supplier ledger.

Answer

Frauds though suppliers ledger: Fraud through supplies ledger could be made in any of the following ways, which the auditor has to take case of:

(1) Adjusting fictitious as duplicate invoices as purchases in the accounts of suppliers and subsequently misappropriating the money when payments are made in respect of these invoices.

(2) Suppressing credit notes issued by suppliers and withdrawing the corresponding amount not claimed by them.

(3) Withdrawing amounts which remain unclaimed for more than the normal time limit for one reason or other by showing the same have been paid to the parties.

(4) Accepting invoices at prices considerably highest than the market price and collecting the excess claim from the suppliers directly.

Question 12

Z Ltd is intending to acquire A Ltd. It hires B & Co., a firm of Chartered Accountants to conduct a due diligence. B & Co., wants to reduce the risk of over valuation of assets in its due diligence exercise. Kindly guide B & Co.

Answer

Due Diligence Exercise in case of Overvalued Assets: Due diligence is an all pervasive exercise to review all important aspects like financial, legal, commercial, etc. before taking any final decision in the matter. As far as any overvalued assets are concerned, this shall form part of such a review. Normally, overvalued assets are not apparent from books of accounts and financial statements. Review of financial statements does involve examination from the view point of extraordinary items, analysis of significant deviations, etc. However, in order to reduce the risk of over valuation of assets, the auditor should pay his attention to the following areas:

Overvalued assets: The auditor shall have to specifically examine the following areas:

1. Uncollected/uncollectable receivables.
2. Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with the name of company.
3. Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.
4. Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue.
5. Litigated assets and property.
6. Investments carried at cost though realizable value is much lower.
7. Investments carrying a very low rate of income / return.
8. Infructuous project expenditure/deferred revenue expenditure etc.
9. Group Company balances under reconciliation etc.
10. Intangibles of no value.

Question 13

You have been appointed to investigate a suspected embezzlement of cash receipts in a departmental store. What are the steps you would take in this regard?

Answer

Investigation of suspected embezzlement of cash receipts: While doing investigation of suspected embezzlement of cash receipts of a departmental store, we would like to take below mentioned steps:

(i) Before proceeding to investigate a suspected embezzlement, the investigating accountant should ascertain the exact duties of the person concerned who is suspected to have committed a fraud; his relationship to the general routine of the office, and the circumstances in which any known instances of defalcation have come to light. Such an enquiry would give a clue to promising avenues of investigation. Greater the authority of the individual suspected of a fraud, wider would be the field which would have to be covered by the investigation.

(ii) He should also examine the line of responsibility between the various members of the staff.

(iii) He should have a look at the system of internal control in operation for spotting out the weaknesses, if any, that may exist in it. Relying on the above study, he should direct his enquiry towards those aspects of the business where there has been excessive control in the hands of single persons, without any supervision by any other person or any other inherent weakness that may be in existence in the system.

(iv) On the assumption that cash may have been diverted before being entered in the books, evidence as regards income received from different sources should be scrutinised, e.g., inventory, sales summaries, rental registers, correspondence with customers, advices of travelling salesmen and counterfoils or receipts.

(v) Carbon copies of receipts marked 'duplicate', should be scrutinised to confirm that they are in fact copies of receipts issued earlier.

(vi) By recalling paying-in-slips from the bank the details of cash deposited on each day should be compared with those shown in the Cash Book.

(vii) The record of sales of scrap of waste paper, that of collection of rents from labourers temporarily accommodated in the company's quarters, that of refunds of amounts

deposited with the electric supply co., and other Government authorities should be examined for finding out if any of these amounts have been misappropriated.

(viii) Cash sales should be vouched in detail. Recoveries from customers and sundry parties should be checked with the copies of receipts issued to them; deductions made on account of cash discounts should be reviewed.

(ix) All withdrawals from the bank should be checked by reference to corresponding entries in the bank pass book.

Question 14

J Ltd is interested in acquiring S Ltd. The valuation of S Ltd is dependent on future maintainable sales. As the person entrusted to value S Ltd what factors would you consider in assessing the future maintainable turnover ?

Answer

In assessing the turnover which the business would be able to maintain in the future, the following factors should be taken into account:

(i) **Trend:** Whether in the past, sales have been increasing consistently or they have been fluctuating. A proper study of this phenomenon should be made.

(ii) **Marketability:** Is it possible to extend the sales into new markets or that these have been fully exploited? Product wise estimation should be made.

(iii) **Political and economic considerations:** Are the policies pursued by the Government likely to promote the extension of the market for goods to other countries? Whether the sales in the home market are likely to increase or decrease as a result of various emerging economic trends?

(iv) **Competition:** What is the likely effect on the business if other manufacturers enter the same field or if products which would sell in competition are placed on the market at cheaper price? Is the demand for competing products increasing? Is the company's share in the total trade constant or has it been fluctuating?

Question 15

What will be your approach in investigation under Section 210 and 213 into the affairs of the company registered under Companies Act, 2013?

Answer

Approach in investigation under section 210 and 213 into the affairs of the Companies: The general approach for investigation under Sections 210 and 213 of the Companies Act, 2013 is conditioned by the legal requirements in these regards. The affairs of the company may include everything such as goodwill, profit and loss, contracts, investments, assets, shareholding in subsidiaries, decision making, etc. Also the specific circumstances mentioned in these sections like fraud, mismanagement, oppression of any shareholder etc. come within the term "affairs of the company."

Investigation under Sections 210 and 213 do not call for any special approach. Approach/Steps for pursuing the investigation are:

(i) Clarity of Terms of Reference: The approach to any investigation is determined on a consideration of the nature of the investigation and the terms of reference. However, the inspector should ensure that the terms of reference are clear, unambiguous and in writing. If he has any doubt about any item in the terms, he should obtain clarification in writing. It should also be, seen that the terms of reference are not too general, because that may frustrate the whole objective of the investigation; the scope of the investigation will become unwieldy and ill defined. An investigation order to investigate into the affairs of the company would be an instance at point. Therefore, the inspector should ask for reframing of the order specifying the exact matters to be investigated. He should also take into consideration the possible effect of limitations, if any, put in the terms of reference and should keep the Central Government informed in writing about their effect on the investigation.

(ii) Scope of Investigation: The next point for consideration of the inspector would be the determination of the scope of the investigation on the basis of the terms of reference. At this stage, it may be useful for the inspector to go into the history of the company and its affiliates or associates. He should evaluate the terms of reference in sketching the scope of investigation; this will enable him to locate the limitation, if any, in the terms of reference, not clearly mentioned. For a purposeful investigation, he may need to stretch his inquiry into the books and records of allied and associated persons and concerns and may require to arm himself with the powers given under the Companies Act.

(iii) Period for investigation: He should also have regard to the period over which the investigation should stretch. The evaluation of terms of reference and the consequential determination of the scope of investigation are the twin props on which the entire investigation would rest and, therefore, the inspector appointed under Sections 210 and 213 should devote careful attention to these.

(iv) Framing of Programme: The next step is the investigator/inspector should frame his programme for investigation in a systematic manner. He should keep adequate working notes and papers with references and cross references in a proper and methodical way to aid him in the preparation of the report. The actual process of investigation would be essentially an evidence gathering procedure and, at every step, he should have regard to the procedures laid down in these sections regarding production of documents and evidence, examination on oath and seizure of documents. He should also keep his mind open to the revelations he comes across in the process of evidence collection and should assess whether the programme of investigation needs amendment or modification.

(v) Using the work of Experts: He should also consider whether assistance of other experts like engineers, lawyers, etc., is necessary in the interest of a comprehensive and full proof examination of the documents and information.

(vi) Legal requirements and investigation Report: Only after he has completed the steps in the investigation programme and has marshaled all the information that he needed should he prepare his report. He, however, can also make interim report. The findings should be completed and exhaustive. Before he makes his final report he should obtain and keep on record the evidences relied upon by him. By the nature of things, such evidence should be as conclusive as possible depending on circumstances of the case. He should make his report in accordance with the provisions of the Companies Act, 2013.

The general approach for investigations under Sections 210 and 213 should, therefore, be formulated having regard to the terms of reference, scope, the period, the programme and procedure of the investigation and the attending legal requirements specified above.

20

Investigation and Due Diligence

Question 1

M Limited is going to acquire S Limited. The purchase consideration has been decided at ₹ 4000 Crores. M Limited is worried about hidden liabilities or overvalued assets of S Limited and approached you to examine the same.

List out eight important transactions/items which you would like to investigate in the Due Diligence exercise. *(4 Marks, November, 2013)*

Or

Z Ltd is intending to acquire A Ltd. It hires B & Co., a firm of Chartered Accountants to conduct a due diligence. B & Co., wants to reduce the risk of over valuation of assets in its due diligence exercise. Kindly guide B & Co. *(8 Marks, May, 2012)*

Or

Your client is contemplating taking over a manufacturing concern and desires that in the course of due diligence review, you should specifically look for hidden liabilities and over valued assets, if any. State in brief the major areas you would examine for the above.

(5 Marks, November, 2010) (8 Marks, November, 2005)

Answer

Major areas to examine in course of Due Diligence Review: Due diligence is an all pervasive exercise to review all important aspects like financial, legal, commercial, etc. before taking any final decision in the matter. As far as any hidden liabilities or overvalued assets are concerned, this shall form part of such a review of Financial Statements. Normally, cases of hidden liabilities and overvalued assets are not apparent from books of accounts and financial statements. Review of financial statements does not involve examination from the view point of extraordinary items, analysis of significant deviations, etc.

However in order to investigate hidden liabilities or over-valued assets the auditor should pay his attention to the following areas:

Important transactions/ items which need to be investigated in the due diligence exercise are-

Items of Hidden liabilities:

- The company may not show any show cause notices which have not matured into demands, as contingent liabilities. These may be material and important.
- The company may have given "Letters of Comfort" to banks and Financial Institutions. Since these are not "guarantees", these may not be disclosed in the Balance sheet of the target company.
- The Company may have sold some subsidiaries/businesses and may have agreed to take over and indemnify all liabilities and contingent liabilities of the same prior to the date of transfer. These may not be reflected in the books of accounts of the company.
- Product and other liability claims; warranty liabilities; product returns/discounts; liquidated damages for late deliveries etc. and all litigation
- Tax liabilities under direct and indirect taxes
- Long pending sales tax assessments
- Pending final assessments of customs duty where provisional assessment only has been completed.
- Agreement to buy back shares sold at a stated price.
- Future lease liabilities
- Environmental problems/claims/third party claims
- Unfunded gratuity/superannuation/leave salary liabilities; incorrect gratuity valuations.
- Huge labour claims under negotiation when the labour wage agreement has already expired.

Items of over-valued assets:

- Uncollected/uncollectable receivables
- Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with name of company
- Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.
- Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue
- Litigated assets and property
- Investments carried at cost though realizable value is much lower
- Investments carrying a very low rate of income / return
- Infructuous project expenditure/deferred revenue expenditure etc.
- Group Company balances under reconciliation etc.
- Intangibles of no value.

Question 2

J Ltd is interested in acquiring S Ltd. The valuation of S Ltd is dependent on future maintainable sales. As the person entrusted to value S Ltd what factors would you consider in assessing the future maintainable turnover? *(4 Marks, May, 2013)*

Answer

In assessing the turnover which the business would be able to maintain in the future, the following factors should be taken into account:

(i) **Trend:** Whether in the past, sales have been increasing consistently or they have been fluctuating. A proper study of this phenomenon should be made.

(ii) **Marketability:** Is it possible to extend the sales into new markets or that these have been fully exploited? Product wise estimation should be made.

(iii) **Political and economic considerations:** Are the policies pursued by the Government likely to promote the extension of the market for goods to other countries? Whether the sales in the home market are likely to increase or decrease as a result of various emerging economic trends?

(iv) **Competition:** What is the likely effect on the business if other manufacturers enter the same field or if products which would sell in competition are placed on the market at cheaper price? Is the demand for competing products increasing? Is the company's share in the total trade constant or has it been fluctuating?

Question 3

You have been appointed to investigate a suspected embezzlement of cash receipts in a departmental store. What are the steps you would take in this regard?

(6 Marks, November, 2013)

Answer

Investigation of suspected embezzlement of cash receipts: While doing investigation of suspected embezzlement of cash receipts of a departmental store, we would like to take below mentioned steps:

(i) Before proceeding to investigate a suspected embezzlement, the investigating accountant should ascertain the exact duties of the person concerned who is suspected to have committed a fraud; his relationship to the general routine of the office, and the circumstances in which any known instances of defalcation have come to light. Such an enquiry would give a clue to promising avenues of investigation. Greater the authority of the individual suspected of a fraud, wider would be the field which would have to be covered by the investigation.

(ii) He should also examine the line of responsibility between the various members of the staff.

(iii) He should have a look at the system of internal control in operation for spotting out the weaknesses, if any, that may exist in it. Relying on the above study, he should direct his enquiry towards those aspects of the business where there has been excessive control in the hands of single persons, without any supervision by any other person or any other inherent weakness that may be in existence in the system.

(iv) On the assumption that cash may have been diverted before being entered in the books, evidence as regards income received from different sources should be scrutinised, e.g., stock, sales summaries, rental registers, correspondence with customers, advices of travelling salesmen and counterfoils or receipts.

(v) Carbon copies of receipts marked 'duplicate', should be scrutinised to confirm that they are in fact copies of receipts issued earlier.

(vi) By recalling paying-in-slips from the bank the details of cash deposited on each day should be compared with those shown in the Cash Book.

(vii) The record of sales of scrap of waste paper, that of collection of rents from labourers temporarily accommodated in the company's quarters, that of refunds of amounts deposited with the electric supply co., and other Government authorities should be examined for finding out if any of these amounts have been misappropriated.

(viii) Cash sales should be vouched in detail. Recoveries from customers and sundry parties should be checked with the copies of receipts issued to them; deductions made on account of cash discounts should be reviewed.

(ix) All withdrawals from the bank should be checked by reference to corresponding entries in the bank pass book.

Question 4

What are the areas in which Due Diligence can take place ? *(5 Marks, May, 2008)*

Answer

Areas in which Due Diligence can take place:

1. Commercial/operational due diligence: It is generally performed by the concerned acquire enterprise involving an evaluation from commercial, strategic and operational perspectives. For example, whether proposed merger would create operational synergies.
2. Financial Due Diligence: It involves analysis of the books of accounts and other information pertaining to financial matters of the entity. It should be performed after completion of commercial due diligence.
3. Tax Due diligence: It is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence .The accountant has to look at the tax affect of the merger or acquisition.
4. Information systems due diligence: It pertains to all computer systems and related matter of the entity.
5. Legal due diligence: This may be required where legal aspects of functioning of the entity are reviewed. For example, the legal aspects of property owned by the entity or compliance with various statutory requirements under various laws.
6. Environmental due diligence: It is carried out in order to study the entity's environment, its flexibility and adaptiveness to the acquirer entity.

7. Personnel due diligence: It is carried out to ascertain that the entity's personnel policies are in line or can be changed to suit the requirements of the restructuring.

Question 5

What are the important aspects to be looked into a due diligence review of Cash flow?

(8 Marks, November, 2007)

Answer

Due Diligence review of cash flow:

(i) Review the historical pattern of cash flows of the organization and look for change in trends.

(ii) See whether the company is able to meet its cash requirements from internal generations/accruals or does it seek outside sources from time to time.

(iii) Check whether the company honours its commitments to creditors, Government and other stock holders.

(iv) Verify the ability of the company to turn its stock into Debtors i.e sale ability of its products.

(v) Ensure that the company follows up with Debtors and that the Debtors collection period is not very large.

(vi) Check the ability of the company to deploy its funds in profitable investment opportunities.

(vii) Look into the investment pattern of the company, whether they give maximum benefits to the company and are easily realizable.

Question 6

In a Company, it is suspected that there has been an embezzlement in cash receipts. As an investigator, what are the areas that you would verify? (8 Marks, November, 2007)

Answer

The following areas need to be verified in this regard:

(i) Issuing a receipt for full amount collected, entering only a lesser amount on the counterfoil.

(ii) Showing a larger cash discount than actually allowed.

(iii) Adjusting a fictitious credit in the account of a customer for goods returned.

(iv) Cash sales entered as credit sales with debit to customer.

(v) Writing off a good debt as bad and irrecoverable to cover up misappropriation of amount collected.

(vi) Short-debiting customer's ledger account and withdrawing the difference on collection of full amount.

(vii) Under-casting the receipts side of cash book; carrying over a shorter total of the receipts from one page of the cash book to the next so as to cover up short banking misappropriated.

(viii) Over-casting the payment side of the cash book; over-carrying the total of the payments from one page of the cash book to the next so as to cover up misappropriation of a part of the amount withdrawn from the bank.

Question 7

Outline the contents of a due diligence report. (8 Marks, May, 2007)

Answer

Contents of a Due Diligence Report: The Contents of a due diligence report vary with individual cases but the following can be illustrative headings:

(i) Executive summary.

(ii) Introduction.

(iii) Background of target.

(iv) Objective of due diligence.

(v) Terms of reference and scope of verification.

(vi) Brief history of the company.

(vii) Summary on capital structure and group structure of company.

(viii) Shareholding pattern.

(ix) Observations on the review.

(x) Assessment of Management structure.

(xi) Assessment of financial liabilities.

(xii) Assessment of valuation of assets.

(xiii) Comments on properties, terms of leases, lien and encumbrances.

(xiv) Assessment of operating results.

(xv) Assessment of taxation and statutory liabilities.

(xvi) Assessment of possible liabilities on account of litigation.

(xvii) Assessment of net worth.

(xviii) Any liabilities not provided for in the books.

(xix) SWOT analysis comments on future projections.

(xx) Status on charges, liens, mortgages and assets of the company.

(xxi) Ways and means to cover unforeseen contingent liabilities.

(xxii) Aspects to be taken care of before/after merger.

(xxiii) Interlocking investments and financial obligations with group/associate companies amounts receivable subject to litigation.

Question 8

A company engaged in manufacturing of chemicals is consistently recording higher sales turnover, but declining net profits since the last 5 years. As an investigator appointed to find out the reasons for the same, what are the points you would verify? (8 Marks, May, 2006)

Answer

Decline in Net Profits Despite Increasing Sales: 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 Salesmix*: 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 salesmix, more quantities of unprofitable products are sold, profits will be reduced inspite 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. Inspite 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.

Question 9

Write short notes on Audit vs. Investigation. (4 Marks, November, 2004)

Answer

Audit vs. Investigation: As Per SA 200 "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with standards on auditing". The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

For auditing on the other hand, the general objective is to find out whether the financial statements show true and fair view. The auditor seeks to report what he finds in the normal course of examination of the accounts adopting generally followed techniques unless circumstances call for a special probe. As per sub section 12 of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure. Fraud, error, irregularity, whatever comes to the auditor's notice in the usual course of checking, are all looked into in depth and sometimes investigation results from the prima facie findings of the auditor.

Investigation implies systematic, critical and special examination of the records of a business for a specific purpose. The examination conducted under investigation is intensive as well as exhaustive so far as the activities or areas of accounting is concerned. Investigation requires a concentrated focus on the subject matter of inquiry and related matters. Often, investigations may spread over a period longer than one year and its scope may extend to inquiry beyond the books of accounts if the circumstances so require.

For example if fraud is suspected and an accountant is called upon to check the accounts to whether fraud really exists and if so, the amount involved, the character of the enquiry changes into investigation. Investigation may be undertaken in numerous areas of accounts, e.g., the extent of waste and loss, profitability, cost of production etc. It extends scope beyond books of accounts.

Etymologically, auditing and investigation are largely overlapping concepts because auditing is nothing but an investigation used in a broad sense. Both auditing and investigation are fact finding techniques but their basic nature and objectives differ as regards scope, frequency, basis, thrust, depth and conclusiveness. Audit and investigation differ in objectives and in their nature. Auditing is general while investigation is specific.

Question 10

Mr. Clean who proposes to buy the proprietary business of Mr. Perfect, engages you as investigating accountant. Specify the areas which you will cover in your investigation.

(8 Marks, May, 2004)

Answer

Areas to be covered in the investigation: The first and foremost important aspect in any business investigation is to have an overall picture of the position of the business which is being investigated before the details are gone into. Further, it is important to know whether the business is engaged in the manufacture of one or two important lines of products, is principally processing materials or is concerned only with the sale of a single product. Also, whether it is a business which depends for its success on imported raw materials or supply of parts and components from ancillary businesses or uses indigenous materials and parts which are manufactured locally. If the business is labour - intensive, its future profitability would be dependent on availability of skilled labour and relations of the management with the trade unions. Labour relations thus can affect the future profitability of the business. The method of distribution of products, either through wholesalers or retailers also must be examined. For studying the economic and financial position of the business, the following should be considered:

(i) The adequacy or otherwise of fixed and working capital. Are these sufficient for the growth of the business?

(ii) What will be the trend of the sales and profits in the future? The success of a business in the future would depend on the position enjoyed by it in the past in relation to its competitors. A business may be successful because it enjoys a monopoly. In such a case, the possibility of emergence of competition must be examined. This may be ascertained on the basis of the trend in market share of the product and the licensing policy followed by the government. Establishing the trend of sales, product-wise and area-wise will ordinarily help in drawing a conclusion on whether the trend will be maintained in the future.

(iii) Whether the profit which the business could be expected to maintain in the future would yield an adequate return on the capital employed?

From the accountant's view point, the following specific areas need to be looked into:

Profit and Loss Account: To study the Profit and Loss Account of a concern and consider each item, included therein, in relation to the corresponding items in the Profit and Loss Account of the previous years. It is therefore, necessary that a summary, in a columnar form, should be prepared of the balances included in the Profit and Loss Accounts of the business for a period, say of 5 to 7 years.

Fixed Assets: Fixed assets, usually, are shown in accounts at cost less depreciation but the accounts do not show the ages of different assets. It is desirable, therefore, to obtain age analysis of various items of fixed assets. Assets which are old or are obsolete would naturally have to be replaced. It should be seen that their values are not in excess of the value of service that they could be expected to render to the business during the balance period of their active life and the amount they would fetch on sale as scrap.

Stock and work-in-progress: It should be seen that stocks have been valued consistently and that the basis of valuation was such that the value placed on stocks did not include any element of profit. Also, there should be due allowance for damaged, obsolete and slow moving stocks.

Other liquid assets: It should be ascertained that the assets so described are readily realisable. Money with a bank in liquidation should be taken only to the extent guaranteed by Deposit Insurance Scheme.

Idle assets: On a scrutiny, it may appear that certain assets are remaining idle and are not being properly applied in the business. For example, certain plant and machinery may have been put to use after a considerable period of time after acquisition. Some of the fixed assets may be awaiting installation even at the valuation time.

Liabilities: The important matter to investigate in this regard is whether those are stated fully or understated or overstated. In other words, whether the profits of the business have been inflated by suppression of liabilities or there are any free reserves included in the liabilities. In either case, an adjustment would be necessary. Secondly, it should be ascertained that liabilities are not unduly 'large or are not outstanding for a long time, in such cases, it would be necessary to pay off some of them which would cause a drain on the liquid resources of the concern. The fact should be stated in the report.

Taxation: Orders in respect of assessments completed should be studied and it should be verified that an adequate provision has been made in respect of liabilities for taxes which have not been assessed. Also, it should be seen that in the past there has been no reopening of assessments. If so, the company may be liable for an undisclosed sum of taxes plus penalties. Any temporary tax benefit should also be disregarded.

Apart from the above areas, the other factors relating to the management, skilled labour, etc. may also be covered in the investigation.

21
Peer Review

Question 1

Write a short note on Scope of peer review.

Answer

Scope of peer review: The Statement on Peer Review lays down the scope of review to be conducted as under:

The Peer Review process shall apply to all the assurance services provided by a Practice Unit.

1. Once a Practice Unit is selected for Review, its assurance engagement records pertaining to the Peer Review Period shall be subjected to Review.
2. The Review shall cover:
   (i) Compliance with Technical, Professional and Ethical Standards:
   (ii) Quality of reporting.
   (iii) Systems and procedures for carrying out assurance services.
   (iv) Training programmes for staff (including articled and audit assistants) concerned with assurance functions, including availability of appropriate infrastructure.
   (v) Compliance with directions and/or guidelines issued by the Council to the Members, including Fees to be charged, Number of audits undertaken, register for Assurance Engagements conducted during the year and such other related records.
   (vi) Compliance with directions and/or guidelines issued by the Council in relation to article assistants and/or audit assistants, including attendance register, work diaries, stipend payments, and such other related records.

Question 2

Write a short note on Technical, ethical and professional standards as per statement on peer review.

Answer

Technical, Ethical and Professional Standards as per statement on peer review: As per the Statement, Technical, Professional and Ethical Standards means-

1. Accounting Standards issued by ICAI and /or prescribed and notified by the Central Government of India;
2. Standards issued by the Institute of Chartered Accountants of India including-
   (i) Engagement standards
   (ii) Statements
   (iii) Guidance notes
   (iv) Standards on Internal Audit
   (v) Statements on Quality Control
   (vi) Notifications / Directions / Announcements / Guidelines / Pronouncements / Professional standards issued from time to time by the Council or any of its committees.
3. Framework for the Preparation and presentation of financial statements, framework of statements and Standard on Auditing, Standard on Assurance Engagements, Standards on Quality Control and Guidance Notes on related services issued, from time to time, by the Institute of Chartered Accountants of India and framework for assurance engagements;
4. Provisions of the various relevant statutes and / or regulations which are applicable in the context of the specific engagements being reviewed including instructions, guidelines, notifications, directions issued by regulatory bodies as covered in the scope of assurance engagements.

Question 3

A, a practicing Chartered Accountant is appointed to conduct the peer review of another practicing unit. What areas A should review in the assessment of independence of the practicing unit?

Answer

Review in the Assessment of Independence of the Practicing Unit – The reviewer should carry out the compliance review of the five general controls, i.e., independence, maintenance of professional skills and standards, outside consultation, staff supervision and development and office administration and evaluate the degree of reliance to be placed upon them. The degree of reliance will, ultimately, affect the attestation service engagements to be reviewed.

A, a practicing Chartered Accountant should review following controls in respect of assessment of independence of the practicing unit:

1. ***Does the practice unit have a policy to ensure independence, objectivity and integrity, on the part of partners and staff? Who is responsible for this policy?***
2. ***Does the practice unit communicate these policies and the expected standards of professional behaviour to all staff?***
3. ***Does the practice unit monitor compliance with policies and procedures relating to independence?***

4. ***Does the practice unit periodically review the practice unit's association with clients to ensure objectivity and independence?***

Question 4

Write a short note on Focus of a Peer review.

Answer

Focus of a Peer review: As per the Statement of Peer Review issued by the Institute of Chartered Accountants of India, Peer Review - means an examination and Review of the systems and procedures to determine whether the same have been put in place by the Practice Unit for ensuring the quality of assurance services as envisaged by the Technical, Professional and Ethical Standards and whether the same were consistently applied in the period under review.

The Review shall cover:

(i) Compliance with Technical, Professional and Ethical Standards.

(ii) Quality of reporting.

(iii) Systems and procedures for carrying out assurance services.

(iv) Training programmes for staff (including articled and audit assistants) concerned with assurance functions, including availability of appropriate infrastructure.

(v) Compliance with directions and / or guidelines issued by the Council to the Members, including Fees to be charged, Number of audits undertaken, register for Assurance Engagements conducted during the year and such other related records.

(vi) Compliance with directions and / or guidelines issued by the Council in relating to article assistants and / or audit assistants, including attendance register, work diaries, stipend payments, and such other related records.

Question 5

Briefly explain Collection of evidences by Peer reviewer.

Answer

Collection of Evidence by Peer Reviewer: A Peer Reviewer collects evidence by applying the following methods:

1. Inspection mainly consists of examination of documentation (working papers) and other records maintained by the practice unit.

2. 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.

3. 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.

Question 6

Write a short note on "Reporting" stage in Peer Review.

Answer

Reporting stage in Peer Review: The Peer Review Report should state that the system of quality control for the assurance services of the Practice Unit for the period under Review has been designed so as to carry out the assurance services in a manner that ensures compliance with Technical, Professional and Ethical standards.

The Peer Review Report shall address the compliance report or otherwise on the following areas of controls:

1. ***Independence.***
2. ***Maintenance of Professional skills and standards.***
3. ***Outside Consultation.***
4. ***Staff recruitment, Supervision and Development.***
5. ***Office Administration:***

   (i) Discussion/Communication of Findings

   (a) After completing the on-site Review, the Reviewer, before making his Report to the Board, shall communicate his findings to the Practice Unit if in his opinion, the systems and procedures are deficient or non-compliant with reference to any matter that has been noticed by him or if there are other matters where he wants to seek clarification.

   (b) The Practice Unit shall within 15 days after the date of receipt of the findings, make any submissions or representations, in writing to the Reviewer.

   (ii) Peer Review Report of Reviewer

   (a) At the end of an on-site Review if the Reviewer is satisfied with the reply received from the Practice Unit, he shall submit a Peer Review Report to the Board along with his initial findings, response by the Practice Unit and the manner in which the responses have been dealt with. A copy of the report shall also be forwarded to the Practice Unit.

(b) In case the Reviewer is of the opinion that the response by the Practice Unit is not satisfactory, the Reviewer shall accordingly submit a modified Report to the Board incorporating his reasons for the same. The Reviewer shall also submit initial findings, response by the Practice Unit and the manner in which the responses have been dealt with. A copy of the report shall also be forwarded to the Practice Unit.

(c) In case of a modified report, The Board shall order for a "Follow On" Review after a period of one year from the date of issue of report as mentioned in (b) above. If the Board so decides, the period of one year may be reduced but shall not be less than six months from the date of issue of the report.

Question 7

Explain the objectives of Peer Review.

Answer

Objectives of Peer Review: The main objective of Peer Review is to ensure that in carrying out the assurance service assignments, the members of the Institute-

(1) comply with Technical, Professional and Ethical Standards as applicable including other regulatory requirements thereto and

(2) have in place proper systems including documentation thereof, to amply demonstrate the quality of the assurance services.

Thus, the primary objective of peer review is not to find out deficiencies but to improve the quality of services rendered by members of the profession. The Statement of Peer Review also makes it clear that the peer review, "does not seek to redefine the scope and authority of the Technical Standards specified by the Council but seeks to enforce them within the parameters prescribed by the Technical Standards". The peer review is directed towards maintenance as well as enhancement of quality of assurance services and to provide guidance to members to improve their performance and adherence to various statutory and other regulatory requirements. Such an objective of the peer review process makes it amply clear that the reviewer is not going to sit on the judgement of the practice unit while rendering assurance services but to evaluate the procedure followed by the practice unit in rendering such a service. Accordingly, where a practice unit is not following technical standards, the reviewers are expected to recommend measures to improve the procedures. To elaborate further, the key objective of peer review exercise is not to identify isolated cases of engagement failure, but to identify weaknesses that are pervasive and chronic in nature. For instance, absence of formal planning of an audit represents a serious deficiency that needs to be remedied by the practice unit. An instance of the auditor not carrying out physical verification of furniture and fixture may not attract the same comment. However, certain items of assets are best verified through the physical verification process and not adopting the same procedure may rightly be viewed as a systemic failure. The conclusion, therefore, is that the peer review seeks to identify and address patterns of non-compliance with quality control standards.

Question 8

Write a short note on Peer Review.

Answer

Peer Review: The term "peer" means a person of similar standing. The term "review" means conduct of re-examination or retrospective evaluation of the subject matter. In general, for a professional, the term "peer review" would mean review of work done by a professional, by another professional of similar standing. 'Peer Review' is defined as, a regulatory mechanism for monitoring the performances of professionals for maintaining quality of service expected of them for enhancing the reliance placed by the users of financial statements for economic decision-making.

As per the Statement of Peer Review issued by the Institute of Chartered Accountants of India, Peer Review - means an examination and Review of the systems and procedures to determine whether the same have been put in place by the Practice Unit for ensuring the quality of assurance services as envisaged by the Technical, Professional and Ethical Standards and whether the same were consistently applied in the period under review. The examination and review of a practice unit would be carried out by a "reviewer", i.e., a member, selected from a panel of reviewers maintained by the Board. The term "practice unit" means members in practice, whether practising individually or as a firm of Chartered Accountants.

Question 9

Write a short note on Preliminary Report under Peer Review.

Answer

Preliminary Report Under Peer Review: In the process of peer review, After completing the on-site Review, if in the opinion of Reviewer, the systems and procedures are deficient or non-compliant with reference to any matter that has been noticed by him or if there are other matters where he wants to seek clarification. Then the Reviewer shall communicate his findings in the Preliminary Report to the Practice Unit, before making his Report to the Board. However, no preliminary report is required in case no deficiencies or non- compliance are noticed by the reviewer.

The reviewer while preparing the preliminary report should review and assess the conclusions drawn from the review that indicates the deficiencies to be reported upon. The preliminary report is addressed to the practice unit. The report, apart from mentioning the areas where systems and procedures of the practice unit have been found to be deficient, should also contain a paragraph that discusses the scope of the review performed by the reviewer. If the reviewer draws a conclusion that there existed a limitation on scope of review, the fact, along with such limitation on the scope of the review, should also be communicated to the practice unit through the preliminary report. The reviewer should prepare the report on his letterhead. The report should be dated and also contain the reviewer's signature and membership number and reviewer's code number allotted by the Board.

Question 10

What are the areas excluded from the scope of peer reviewer?

Answer

Areas excluded from scope of Peer Reviewer are:

(i) Management Consultancy Engagements;

(ii) Representation before various Authorities;

(iii) Engagements to prepare tax returns or advising clients in taxation matters;

(iv) Engagements for the compilation of financial statements;

(v) Engagements solely to assist the client in preparing, compiling or collating information other than financial statements;

(vi) Testifying as an expert witness;

(vii) Providing expert opinion on points of principle, such as Accounting Standards or the applicability of certain laws, on the basis of facts provided by the client; and

(viii) Engagement for Due diligence.

21
Peer Review

Question 1

Write short notes on Scope of peer review.

(4 Marks, November, 2013) (4 Marks, November, 2011)

Answer

Scope of peer review: The Statement on Peer Review lays down the scope of review to be conducted as under:

The Peer Review process shall apply to all the assurance services provided by a Practice Unit.

1. Once a Practice Unit is selected for Review, its assurance engagement records pertaining to the Peer Review Period shall be subjected to Review.
2. The Review shall cover:
   (i) Compliance with Technical, Professional and Ethical Standards:
   (ii) Quality of reporting.
   (iii) Systems and procedures for carrying out assurance services.
   (iv) Training programmes for staff (including articled and audit assistants) concerned with assurance functions, including availability of appropriate infrastructure.
   (v) Compliance with directions and/or guidelines issued by the Council to the Members, including Fees to be charged, Number of audits undertaken, register for Assurance Engagements conducted during the year and such other related records.
   (vi) Compliance with directions and/or guidelines issued by the Council in relation to article assistants and/or audit assistants, including attendance register, work diaries, stipend payments, and such other related records.

Question 2

Write short notes on Technical, ethical and professional standards as per statement on peer review. *(4 Marks, May, 2013)*

Answer

Technical, Ethical and Professional Standards as per statement on peer review: As per the Statement, Technical, Professional and Ethical Standards means-

1. Accounting Standards issued by ICAI and /or prescribed and notified by the Central Government of India;
2. Standards issued by the Institute of Chartered Accountants of India including-
   (i) Engagement standards
   (ii) Statements
   (iii) Guidance notes
   (iv) Standards on Internal Audit
   (v) Statements on Quality Control
   (vi) Notifications / Directions / Announcements / Guidelines / Pronouncements / Professional standards issued from time to time by the Council or any of its committees.
3. Framework for the Preparation and presentation of financial statements, framework of statements and Standard on Auditing, Standard on Assurance Engagements, Standards on Quality Control and Guidance Notes on related services issued, from time to time, by the Institute of Chartered Accountants of India and framework for assurance engagements;
4. Provisions of the various relevant statutes and / or regulations which are applicable in the context of the specific engagements being reviewed including instructions, guidelines, notifications, directions issued by regulatory bodies as covered in the scope of assurance engagements.

Question 3

A, a practicing Chartered Accountant is appointed to conduct the peer review of another practicing unit. What areas A should review in the assessment of independence of the practicing unit? *(4 Marks, May, 2012)*

Answer

Review in the Assessment of Independence of the Practicing Unit – The reviewer should carry out the compliance review of the five general controls, i.e., independence, maintenance of professional skills and standards, outside consultation, staff supervision and development and office administration and evaluate the degree of reliance to be placed upon them. The degree of reliance will, ultimately, affect the attestation service engagements to be reviewed.

A, a practicing Chartered Accountant should review following controls in respect of assessment of independence of the practicing unit:

1. Does the practice unit have a policy to ensure independence, objectivity and integrity, on the part of partners and staff? Who is responsible for this policy?
2. Does the practice unit communicate these policies and the expected standards of professional behaviour to all staff?

3. Does the practice unit monitor compliance with policies and procedures relating to independence?
4. Does the practice unit periodically review the practice unit's association with clients to ensure objectivity and independence?

Question 4

Write short notes on Focus of a Peer review. *(5 Marks, May, 2010)*

Answer

Focus of a Peer review: As per the Statement of Peer Review issued by the Institute of Chartered Accountants of India, Peer Review - means an examination and Review of the systems and procedures to determine whether the same have been put in place by the Practice Unit for ensuring the quality of assurance services as envisaged by the Technical, Professional and Ethical Standards and whether the same were consistently applied in the period under review.

The Review shall cover:

(i) Compliance with Technical, Professional and Ethical Standards.

(ii) Quality of reporting.

(iii) Systems and procedures for carrying out assurance services.

(iv) Training programmes for staff (including articled and audit assistants) concerned with assurance functions, including availability of appropriate infrastructure.

(v) Compliance with directions and / or guidelines issued by the Council to the Members, including Fees to be charged, Number of audits undertaken, register for Assurance Engagements conducted during the year and such other related records.

(vi) Compliance with directions and / or guidelines issued by the Council in relating to article assistants and / or audit assistants, including attendance register, work diaries, stipend payments, and such other related records.

Question 5

Briefly explain Collection of evidences by Peer reviewer. *(4 Marks, November, 2009)*

Answer

Collection of Evidence by Peer Reviewer: A Peer Reviewer collects evidence by applying the following methods:

1. Inspection mainly consists of examination of documentation (working papers) and other records maintained by the practice unit.
2. 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.
3. 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.

Question 6

Write short notes on "Reporting" stage in Peer Review. *(4 Marks, June, 2009)*

Answer

Reporting stage in Peer Review: The Peer Review Report should state that the system of quality control for the assurance services of the Practice Unit for the period under Review has been designed so as to carry out the assurance services in a manner that ensures compliance with Technical, Professional and Ethical standards.

The Peer Review Report shall address the compliance report or otherwise on the following areas of controls:

1. Independence.
2. Maintenance of Professional skills and standards.
3. Outside Consultation.
4. Staff recruitment, Supervision and Development.
5. Office Administration:
   - (i) Discussion/Communication of Findings
     - (a) After completing the on-site Review, the Reviewer, before making his Report to the Board, shall communicate his findings to the Practice Unit if in his opinion, the systems and procedures are deficient or non-compliant with reference to any matter that has been noticed by him or if there are other matters where he wants to seek clarification.
     - (b) The Practice Unit shall within 15 days after the date of receipt of the findings, make any submissions or representations, in writing to the Reviewer.
   - (ii) Peer Review Report of Reviewer
     - (a) At the end of an on-site Review if the Reviewer is satisfied with the reply received from the Practice Unit, he shall submit a Peer Review Report to the Board along with his initial findings, response by the Practice Unit and the

manner in which the responses have been dealt with. A copy of the report shall also be forwarded to the Practice Unit.

(b) In case the Reviewer is of the opinion that the response by the Practice Unit is not satisfactory, the Reviewer shall accordingly submit a modified Report to the Board incorporating his reasons for the same. The Reviewer shall also submit initial findings, response by the Practice Unit and the manner in which the responses have been dealt with. A copy of the report shall also be forwarded to the Practice Unit.

(c) In case of a modified report, The Board shall order for a "Follow On" Review after a period of one year from the date of issue of report as mentioned in (b) above. If the Board so decides, the period of one year may be reduced but shall not be less than six months from the date of issue of the report.

Question 7

Explain the objectives of Peer Review. *(4 Marks, November, 2008)*

Answer

Objectives of Peer Review: The main objective of Peer Review is to ensure that in carrying out the assurance service assignments, the members of the Institute-

(1) comply with Technical, Professional and Ethical Standards as applicable including other regulatory requirements thereto and

(2) have in place proper systems including documentation thereof, to amply demonstrate the quality of the assurance services.

Thus, the primary objective of peer review is not to find out deficiencies but to improve the quality of services rendered by members of the profession. The Statement of Peer Review also makes it clear that the peer review, "does not seek to redefine the scope and authority of the Technical Standards specified by the Council but seeks to enforce them within the parameters prescribed by the Technical Standards". The peer review is directed towards maintenance as well as enhancement of quality of assurance services and to provide guidance to members to improve their performance and adherence to various statutory and other regulatory requirements. Such an objective of the peer review process makes it amply clear that the reviewer is not going to sit on the judgement of the practice unit while rendering assurance services but to evaluate the procedure followed by the practice unit in rendering such a service. Accordingly, where a practice unit is not following technical standards, the reviewers are expected to recommend measures to improve the procedures. To elaborate further, the key objective of peer review exercise is not to identify isolated cases of engagement failure, but to identify weaknesses that are pervasive and chronic in nature. For instance, absence of formal planning of an audit represents a serious deficiency that needs to be remedied by the practice unit. An instance of the auditor not carrying out physical verification of furniture and fixture may not attract the same comment. However, certain items of assets are best verified through the physical verification process and not adopting the same procedure may rightly be viewed as a systemic failure. The conclusion, therefore, is that the peer review seeks to identify and address patterns of non-compliance with quality control standards.

Question 8

Write short notes on Peer Review. *(4 Marks, November, 2007)*

Answer

Peer Review: The term "peer" means a person of similar standing. The term "review" means conduct of re-examination or retrospective evaluation of the subject matter. In general, for a professional, the term "peer review" would mean review of work done by a professional, by another professional of similar standing. 'Peer Review' is defined as, a regulatory mechanism for monitoring the performances of professionals for maintaining quality of service expected of them for enhancing the reliance placed by the users of financial statements for economic decision-making.

As per the Statement of Peer Review issued by the Institute of Chartered Accountants of India, Peer Review - means an examination and Review of the systems and procedures to determine whether the same have been put in place by the Practice Unit for ensuring the quality of assurance services as envisaged by the Technical, Professional and Ethical Standards and whether the same were consistently applied in the period under review. The examination and review of a practice unit would be carried out by a "reviewer", i.e., a member, selected from a panel of reviewers maintained by the Board. The term "practice unit" means members in practice, whether practising individually or as a firm of Chartered Accountants.

Question 9

Write short notes on Preliminary Report under Peer Review. *(4 Marks, May, 2005)*

Answer

Preliminary Report Under Peer Review: In the process of peer review, After completing the on-site Review, if in the opinion of Reviewer, the systems and procedures are deficient or non-compliant with reference to any matter that has been noticed by him or if there are other matters where he wants to seek clarification. Then the Reviewer shall communicate his findings in the Preliminary Report to the Practice Unit, before making his Report to the Board. However, no preliminary report is required in case no deficiencies or non- compliance are noticed by the reviewer.

The reviewer while preparing the preliminary report should review and assess the conclusions drawn from the review that indicates the deficiencies to be reported upon. The preliminary report is addressed to the practice unit. The report, apart from mentioning the areas where systems and procedures of the practice unit have been found to be deficient, should also contain a paragraph that discusses the scope of the review performed by the reviewer. If the reviewer draws a conclusion that there existed a limitation on scope of review, the fact, along with such limitation on the scope of the review, should also be communicated to the practice unit through the preliminary report. The reviewer should prepare the report on his letterhead. The report should be dated and also contain the reviewer's signature and membership number and reviewer's code number allotted by the Board.

22

Professional Ethics

Schedules to the Act

Acts or omissions which comprise professional misconduct within the meaning of Section 22 of the Chartered Accountants Act are defined in two Schedules viz. The First Schedule and the Second Schedule.

The First Schedule is divided into four parts, Part I of the First Schedule deals with the misconduct of a member in practice which would have the effect generally of compromising his position as an independent person. Part II deals with misconduct of members in services. Part-III deals with the misconduct of members generally and part IV deals with other misconduct in relation to members of the institute generally. The Second Schedule is divided into three parts. Part I deals with misconduct in relation to a member in practice, Part II deals with misconduct of members generally and part III deals with other misconduct in relation to members of the Institute generally. The implication of the different clauses in the schedules are discussed below:

<u>The First Schedule</u> -

PART I - Professional misconduct in relation to Chartered Accountants in practice

A Chartered Accountant in practice is deemed to be guilty of professional misconduct if he:

Clause (1) allows any person to practice in his name as a chartered accountant unless such person is also a chartered accountant in practice and is in partnership with or employed by him;

Clause (2) pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services to time in or outside India;

Clause (3) accepts or agrees to accept any part of the profits of the professional work of a person who is not a member of the Institute:

Clause (4) enters into partnership, in or outside India, with any person other then Chartered Accountant in practice or such other person who is a member of any other professional body having such qualifications as may be prescribed, including a resident who but for his residence abroad would be entitled to be registered as a member under close (V) of sub-section (1) of section 4 or whose qualifications are recognized by the Central Government or the Council for the purpose of permitting such partnerships;

Clause (5) Secures either through the services of a person who is not an employee of such Chartered Accountant or who is not his partner or by means which are not open to a Chartered Accountant, any professional business ;

Provided that nothing herein contained shall be construed as prohibiting any agreement permitted in terms of item (2), (3) and (4) of this part.

Clause (6) Solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means;

Provided that nothing herein contained shall be construed as preventing or prohibiting -

(i) Any Chartered Accountant from applying or requesting for or inviting or securing professional work from another chartered accountant in practice ; or

(ii) A member from responding to tenders or enquiries issued by various users of professional services or organizations from time to time and securing professional work as a consequence.

Clause (7) "Advertises his professional attainments or services, or uses any designation or expressions other than the Chartered Accountant on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a University established by law in India or recognized by the Central Government or a title indicating membership of the Institute of Chartered Accountants or of any other institution that has been recognized by the Central Government or may be recognized by the Council.

Provided that a member in practice may advertise through a write up, setting out the service provided by him or his firm and particulars of his firm subject to such guidelines as may be issued by the Council.

Clause (8) Accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been Issued certificate under the Restricted Certificate Rules, 1932 without first communicating with him in writing;

Clause (9) Accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Section 225 of the Companies Act, 1956, In respect of such appointment have been duly complied with".

(Now Section 139 and 140 read with Section 141 of the Companies Act, 2013. Students may note that till the time Code of Ethics etc. bare documents get updated from Ethical Standard Board of ICAI in pursuance of the Companies Act, 2013, students are required to understand the basic nature of the provision and quote the same along with the new corresponding provisions.)

Clause (10) "Charges or offers to charge, accepts or offers to accept In respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except as permitted under any regulations made under this Act."

The Council of the Institute has however framed Regulation 192 which exempts members from the operation of this clause in certain professional services. The said Regulation 192 is reproduced -

192. Restriction on fees - No Chartered Accountant in practice shall charge or offer to charge, accept or offer to accept, in respect of any professional work, fees which are based on a percentage of profits, or which are contingent upon the findings or results of such work, provided that

(a) "In the case of a receiver or a liquidator, the fees may be based on a percentage of the realization or disbursement of the assets;

(b) In the case of an auditor of a co-operative society, the fees may be based on a percentage of the paid up capital or the working capital or the gross or net income or profits; and

(c) In the case of a valuer for the purposes of direct taxes and duties, the fees may be based on a percentage of the value of property valued."

Clause (11) Engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage;

Provided that nothing contained herein shall disentitle a chartered accountant from being a director of a company (Not being managing director or a whole time director) unless he or any of his partners is Interested in such company as an auditor."

Clause (12) "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".

PART II - Professional misconduct in relation to members of the Institute in service

A member of the Institute (other than a member in practice) shall be deemed to be guilty of professional misconduct, if he being an employee of any company, firm or person

Clause (1) pays or allows or agrees to pay directly or indirectly to any person any share in the emoluments of the employment undertaken by him;

Clause (2) accepts or agrees to accept any part of fees, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

[Note: A member in the foregoing circumstances would be guilty of misconduct regardless of the fact that he was in whole-time or part-time employment or that he was holding Certificate of Practice along with his employment.]

PART III - Professional misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he

Clause (1) not being a fellow of the Institute, acts as a fellow of the Institute;

Clause (2) does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority;

Clause (3) while inviting professional work from another chartered accountant or while responding to tenders or enquiries or while advertising through a write up, or anything as provided for in items (6) and (7) of Part I of this Schedule, gives information knowing it to be false.

PART IV- Other misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he

(1) is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months;

(2) 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 his professional work.

These clause (1) & (2) are self explanatory and any of the member of the Institute is found guilty by any civil or criminal court and prosecuted for an imprisonment in an offence involving moral turpitude or his acts bring disrepute to the profession or the Institute, irrespective of the fact whether such acts are related to profession or not, such member will be deemed to be guilty of other misconduct in Part IV of Schedule I

The important point to note is that if imprisonment tenure exceeds six months, this case will be covered in the clause of Part III of Schedule II.

<u>The Second Schedule</u> -

Part I - Professional misconduct in relation to chartered Accountant in practice

A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he

Clause (1) "Discloses Information acquired in the course of his professional engagement to any person other than his client so engaging him without the consent of his client or otherwise than as required by any law for the time being in force".

Clause (2) "If he certifies or submits in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee In his firm or by another chartered accountant in practice".

Clause (3) "Permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in manner which may lead to the belief that he vouches for the accuracy of the forecast".

Clause (4) Expresses his opinion on financial statements of any business or enterprise in which he, his firm, or a partner in his firm has a substantial interest;

Clause (5) fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement not misleading where he is concerned with that financial statement in a professional capacity.

Clause(6) "Fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity".

Clause (7) does not exercise due diligence, or is grossly negligent in the conduct of his professional duties

Clause (8) "Fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion".

Clause (9) "Fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances".

Clause (10) fails to keep moneys of his client other than fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.

PART II - Professional misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he

Clause (1) contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council;

Clause (2) being an employee of any company, firm or person, discloses confidential information acquired in the course of his employment except as and when required by any law for the time being in force or except as permitted by the employer;

Clause (3) Includes in any information, statement, return or form to be submitted to the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline. Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false;

Clause (4) Defalcates or embezzles money received in his professional capacity.

Part III - Other misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other mis-conduct, if he is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term exceeding six months.

Imprisonment awarded for a term exceeding six months in any civil/criminal matter treated as a major offence under 'other misconduct' is included in this Schedule.

Where the Director (Discipline) is of the opinion that a member is guilty of any professional or other misconduct mentioned in the second schedule or in both the Schedule, he shall place the matter before the Disciplinary Committee.

Question 1

Comment on the following with reference to the Chartered Accountants Act, 1949 and Schedules thereto:

(a) Mr. S, a Chartered Accountant published a book and gave his personal details as the author. These details also mentioned his professional experience and his present association as partner with M/s RST, a firm.

(b) Mr. C accepted the statutory audit of M/s PSU Ltd., whose net worth is negative for the year 2012-13. The audit was to be conducted for the year 2013-14. The audited accounts for the year 2013-14 showed liability for payment of tax audit fees of ₹ 15,000 in favour of Mr E, the previous auditor.

(c) ***M/s PQR, a firm of Chartered Accountants with 5 partners has accepted the audit of ABC Pvt. Ltd. for 2013-14 at an audit fee of ₹ 2,500. ABC Pvt. Ltd was incorporated in April, 2011, but had commenced operations in January, 2014.***

(d) Mr. P, a Chartered Accountant in practice entered into a partnership with Mr. L, an advocate for sharing of fees for work sent by one to the other. However, due to some disputes, the partnership was dissolved after 1 month without any fees having been received.

Answer

(a) Soliciting Professional Work: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 refers to professional misconduct of a member in practice if he solicits client or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means. Therefore, members should not adopt any indirect methods to advertise their professional practice with a view to gain publicity and thereby solicit clients or professional work. Such a restraint must be practiced so that members may maintain their independence of judgement and may be able to command the respect of their prospective clients. While elaborating forms of soliciting work, the Council has specified that a member is not permitted to indicate in a book or an article, published by him, the association with any firm of chartered accountants. In this case, Mr. S a Chartered Accountant published the book and mentioned his professional experience and his association as a partner with M/s RST, a firm of chartered accountants.

Mr. S being a chartered accountant in practice has committed the professional misconduct by mentioning that at present he is a partner in M/s. RST, a chartered accountants firm.

(b) Accepting Appointment as an Auditor: As per Chapter 7 of Council General Guidelines 2008, a member of the Institute of Chartered Accountants of India in practice shall be deemed to be guilty of professional misconduct if he accepts appointment as auditor of an entity in case the undisputed audit fee of another chartered accountant for carrying out the statutory audit under Companies Act or various other statutes has not been paid.

As per the proviso, such prohibition shall not apply in case of a sick unit where a sick unit is defined to mean "where the net worth is negative".

In the instant case, though the undisputed fees are unpaid, Mr C would still not be guilty of professional misconduct since the M/s PSU Ltd. is a sick unit having negative net worth for the year 2012-13.

(c) ***Minimum Audit Fee: Prescribed minimum audit fee is recommendatory, not mandatory in nature. Therefore, acceptance of audit assignment by M/s PQR, a firm of Chartered Accountants having 5 partners of ABC Pvt. Ltd. for audit fees of ₹2,500 is not violation of any provisions.***

Therefore M/s PQR will not be held liable for guilty of misconduct.

(d) Partnership with non-chartered accountants: As per clause 4 of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant will be guilty of professional misconduct if he enters into partnership with any person other than a chartered accountant in practice or a person resident without India who but for his residence abroad would be entitled to be registered as a member under Clause (v) of Sub-section (1) of Section 4 or whose qualification are recognized by the Central Government or the Council for the purpose of permitting such partnership.

This clause puts a restriction on entering into partnership with a non-chartered accountant for the practice of the profession of chartered accountancy. In the instant case since Mr. P, a chartered accountant, has entered into partnership with Mr. L, an advocate, he would be guilty of professional misconduct irrespective of the fact that no work or fee was shared and the partnership was dissolved after one month since the clause does not permit entering into partnership.

Question 2

Write short notes on Record of Audit Assignments (as required by ICAI regulations).

Answer

Record of Audit assignments: In exercise of the powers conferred by Chapter 8 of Council General Guidelines 2008, the Council of the Institute of Chartered Accountants of India specified that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the "specified number of audit assignments of the companies under Section 224 and /or Section 228 of the Companies Act, 1956 ***(Now under Section 141(3)(g) and 143 of the Companies Act, 2013).*** As a part of this clause, to meet its requirements, a Chartered Accountants in practice as well as a firm in practice shall maintain a record of the audit assignments accepted as laid out in guidelines issued by the Council of the ICAI under Part II of Second Schedule to the Chartered Accountants Act, 1949 in respect of ceiling on audits containing following particulars:

(i) Name of Company Audit/ Assignment.

(ii) Regn. No.

(iii) Date of appointment with Registrar of Companies.

(iv) Date of acceptance.

(v) Date on which form 23B filed ***(Now Form ADT-1 as per the provisions and rules made under Companies Act, 2013)***.

Question 3

Comment on the following with reference to the Chartered Accountants Act, 1949 and Schedules thereto:

(a) L, a chartered accountant did not maintain books of account for his professional earnings on the ground that his income is less than the limits prescribed u/s 44AA of the Income Tax Act, 1961.

(b) M/s. ABC, a firm of Chartered Accountants has taken a loan for acquiring computers, from a company whose Managing Directors' son is an Articled Trainee with A, a partner of M/s ABC.

(c) M/s XYZ, a firm of Chartered Accountants created a website "www.xyzindia.com". The website besides containing details of the firm and bio-data of the partners also contains the photographs of all the partners of the firm.

(d) Z, a Chartered Accountant, certifies a financial forecast of his client which was forwarded to the client's bank based on which the bank sanctioned a loan to the client.

Answer

(a) Maintenance of Books of Account: As per the Council General Guidelines 2008, under Chapter 5 on maintenance of books of accounts, it is specified that if a chartered accountant in practice or the firm of Chartered Accountants of which he is a partner fails to maintain and keep in respect of his/its professional practice, proper books of account including the Cash Book and Ledger, he is deemed to be guilty of professional misconduct. Accordingly, it does not matter whether section 44AA of the Income Tax Act, 1961 applies or not. Hence, Mr. L is guilty of professional misconduct.

(b) Loan from a Company: As per Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949, a chartered accountant is deemed to be guilty of professional misconduct if he contravenes any of the provisions of Chartered Accountants Act, 1949 or Regulations made thereunder. Regulation 47 of the Chartered Accountant's Regulations, 1988, prohibits a member from accepting any premiums or loans or any deposit in any form from an articled clerk directly or indirectly. However, M/s ABC has taken loan from a company whose Managing Director happens to be father of articled clerk with Mr. A, a partner of M/s ABC. In this case, the articled trainee has no direct interest in that company. There has been a case wherein a chartered accountant was held guilty of professional misconduct because he took a loan from a firm in which

the articled clerk and his father were both interested. But, in this case as per the facts, the articled trainee has no direct interest in the company. However, if relationship, direct or indirect, can be established in view of relationship of articled trainee with MD of the company, Mr. A of M/s ABC would be held liable for professional misconduct. Thus, M/s ABC would be guilty of professional misconduct under this clause if it is proved that the loan was related to the engagement of the articled clerk.

(c) Hosting Details on Website: As per detailed guidelines of the ICAI laid down in Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant of the firm can create its own website using any format subject to guidelines. However, the website should be so designed that it does not solicit clients or professional work and should not amount to direct or indirect advertisement. The guidelines of the ICAI to allow a firm to put up the details of the firm, bio-data of partners and display of a passport size photograph. In the case of M/s XYZ, all the guidelines seem to have been complied and there appears to be no violation of the Chartered Accountants Act, 1949 and its Regulations.

(d) Certification of Financial Forecast: Under Clause (3) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice is deemed to be guilty of professional misconduct if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast. Accuracy does not refer to arithmetical accuracy. All forecasts are estimates based on certain assumptions duly evaluated on a consideration of various relevant factors and cannot be ascertained with accuracy. The Guidance Note on Accountants Report on Profit Forecasts and/or Financial forecasts considered the implications of this clause and made it clear that the chartered accountant can participate in the preparation of profit or financial forecasts and review them. But, first of all, he should clearly indicate in his report the sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts and, secondly, he should not vouch for the accuracy of the forecasts. In the instant case, Mr. Shankar is deemed to be guilty as it appears that he has certified the financial forecast without taking adequate safeguards.

Question 4

Do you approve of the following? If not, why?

(a) A firm of Chartered Accountants was appointed by a company to evaluate the costs of the various products manufactured by it for its information system. One of the partners of the firm was a Non-Executive Director of the company.

(b) Mr. Qureshi, Chartered Accountant, in practice died in a road accident. His widow proposes to sell the practice of her husband to Mr. Pardeshi, Chartered Accountant, for ₹ 5 lakhs. The price also includes right to use the firm name - Qureshi and Associates. Can widow of Qureshi sell the practice and can Mr. Pardeshi continue to practice in that name as a proprietor?

Answer

(a) Evaluation of Cost of Products: Clause 4 of Part I of the Second Schedule to Chartered Accountants Act, 1949, states that expressing an opinion on financial statements of any business or any enterprise in which the auditor, his firm or a partner in his firm has a substantial interest would constitute misconduct. Also, the Council of the Institute of Chartered Accountants of India has stated that in cases where a member of the Institute is a director of a company, or the firm in which the said member is a partner, should not express any opinion on its financial statements. As per facts of the case, the firm has been retained to evaluate the cost of products manufactured by it for its information system. It is a part of management consultancy service of the firm and moreover its partner was on the Board. Hence, the firm can perform this assignment and it will not constitute misconduct. However, the firm while accepting the position as auditor in future would have to consider whether it would be possible to act in independent manner and express opinion on financial statements.

(b) Sale of Goodwill: With reference to Clause (2) of Part I to the First Schedule to Chartered Accountants' Act, 1949, the Council of the Institute of Chartered Accountants of India had an occasion to consider whether the goodwill of a proprietary concern of chartered accountant can be sold to another member who is otherwise eligible, after the death of the proprietor. It lay down that the sale is permitted subject to certain conditions. It further resolved that the legal heir of the deceased member has to obtain the permission of the Council within a year of the death of the proprietor concerned. Thus, in a given case and on the facts, the widow of Mr. Qureshi, who has sold the practice for ₹ 5 lakhs is nothing but sale of goodwill. Thus the act of Mrs. Qureshi is permissible.

Question 5

Write short notes on Other Misconduct.

Answer

Other Misconduct:

(i) A member is liable to disciplinary action under Section 21 of the Chartered Accountant Act if he is found guilty of any professional or 'other misconduct'.

(ii) Other misconduct has been defined in Part IV of First Schedule and Part III of Second Schedule in the CA (Amendment Act) 2006.

(iii) As per Part IV of First Schedule of the CA Act, a member of the Institute whether in practice or not, shall be deemed to be guilty of other misconduct if he-

1. Is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months.
2. 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 his professional work.

(iv) As per Part III of Second Schedule to the CA Act, a member of the Institute whether in practice or not shall be deemed to be guilty of other misconduct if he Is held guilty by any

civil or criminal court for an offence which is punishable with imprisonment for a term exceeding six months.

This provision empowers the Council to enquire any misconduct of a member even if it does not arise of professional misconduct.

Some illustrative examples, where a member may be found guilty of "Other Misconduct", under the aforesaid provisions rendering, himself unfit to be member are:

(i) Where a chartered accountant retains the books of account and documents of the client and fails to return these to the client on request without a reasonable cause.

(ii) Where a chartered accountant makes a material misrepresentation.

(iii) Where a chartered accountant uses the services of his articled or audit clerk for purposes other than professional practice.

(iv) Conviction by a competent court of law for any offence under Section 8(v) of the Chartered Accountants Act 1949.

(v) Misappropriation by office-bearer of a Regional Council of the Institute, of a large amount and utilisation thereof for his personal use.

(vi) Non-replying within a reasonable time and without a good cause to the letter of the public authorities.

(vii) Where certain assessment records of income tax department belonging to the client of Chartered Accountant were found in the almirah of the bed-room of the chartered accountant.

(viii) Where a chartered accountant had adopted coercive methods on a bank for having a loan sanctioned to him.

Question 6

Comment on the following with reference to Chartered Accountants Act, 1949 and schedules thereto:

(a) Mr. Parekh, a Chartered Accountant was invited by the Chamber of Commerce to present a paper in a symposium on the issues facing Indian Leather Industry. During the course of his presentation he shared some of the vital information of his client's business under the impression that it will help the Nation to compete with other countries at international level.

(b) Mr. Shah, a Chartered Accountant certified the financial statements of a company in which his wife is a Director holding substantial interest.

(c) Mr. Joe, a Chartered Accountant during the course of audit of M/s XYZ Ltd. came to know that the company has taken a loan of ₹ 10 lakhs from Employees Provident Fund. The said loan was not reflected in the books of account. However, the auditor ignored this information in his report.

(d) Mr. Jain, a Chartered Accountant certified the circulation of "Good Luck" a weekly magazine without examination of financial records and other required documents.

(e) A charitable institution entrusted ₹ 10 lakhs with its auditors M/s Ram and Co., a Chartered Accountant firm, to invest in a profitable portfolio. The auditors pending investment of the money, deposited it in their Savings bank account and no investment was made in the next three months.

Answer

(a) 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. Parekh 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.

(b) Disclosure of Substantial Interest: Clause (4) of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that if an auditor expresses his opinion on the financial statements of any business in which he, his firm or partner in his firm or his relative has substantial interest, he is committing professional misconduct. The Council also emphasizes that the aforesaid requirement of Clause (4) is equally applicable while performing all types of attest functions by the members. In the given case, Mr. Shah, Chartered Accountant, has certified the financial statements of a company in which his wife is a director with substantial interest. Hence this amounts to professional misconduct which attracts clause (4) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

(c) Failure to Disclose Material Facts: As per Clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered Accountant in practice will be held liable for misconduct if he fails to disclose a material fact known to him, which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading. In this case, Mr. Joe has come across information that a loan of ₹ 10 lakhs has been taken by the company from Employees Provident Fund. This is contravention of Rules and the said loan has not been reflected in the books of accounts. Further, this material fact has also to be disclosed in the financial statements. The very fact that Mr. Joe has failed to disclose this fact in his report, he is attracted by the provisions of professional misconduct under clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

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

certified the circulation figures of Good Luck, a weekly magazine without examination of financial records and other required documents. The chartered accountant should not express his opinion before obtaining the required data and information. As an auditor, Mr Jain ought to have verified the basic records such as print order, printer's bill, number of copies sold and paid for, number of copies returned unsold to ensure the correctness of circulation figures. Thus in the present case, Mr. Jain will be held guilty of professional misconduct.

(e) **Failure to keep Money in separate Bank Account:** If a Chartered Accountant in practice fails to keep moneys of his clients in a separate bank account or fails to use such moneys for purposes for which they are intended then his action would amount to professional misconduct under clause 10 of Part I of Second Schedule to the Chartered Accountants Act, 1949. In the course of his engagement as a professional accountant, a member may be entrusted with moneys belonging to his client. If he should receive such funds, it would be his duty to deposit them in a separate banking account, and to utilise such funds only in accordance with the instructions of the client or for the purposes intended by the client. In the given case by depositing the client's money by M/s Ram and Co., a firm of Chartered Accountants, in their own savings bank account, the auditors have committed a professional misconduct. Hence in the given case, M/s Ram & Co. will be held guilty of professional misconduct.

Question 7

Discuss whether the following actions by a Chartered Accountant would amount to misconduct or not:

(i) A Chartered Accountant practising in India enters into partnership with

(a) A Certified Public Accountant in New York.

(b) A Chartered Accountant from the Institute of Chartered Accountants in England and Wales in London, and in each case, the members concerned take the profits earned in their own country.

Will it make any difference, if an Indian Chartered Accountant is practising outside India and becomes a partner with the aforesaid accountants?

(ii) A practising Chartered Accountant uses a visiting card in which he designates himself, besides as Chartered Accountant, as

(a) Tax Consultant

(b) Cost Accountant.

Answer

(i) (a) **Partnership with a CPA in New York:** Clause (4) of Part I to the First Schedule to the Chartered Accountants Act, 1949 specifies that a chartered accountant in practice shall be deemed to be guilty of professional misconduct if he enters into partnership, in or outside India, with any person other than a chartered accountant in practice or such other person who is a member of any other professional body having such qualifications as may be prescribed, including a resident who but for his residence abroad would be entitled to be registered as a member or whose qualifications are recognised by the Central Government or the Council for the purpose of permitting such partnerships;

Thus, chartered accountant would be guilty of professional misconduct since certified public accountants (CPA) are not eligible to become members of the Institute.

(b) **Partnership with a chartered accountant from ICAEW:** As stated above, it is important that partnership with a member of the foreign professional body is permissible provided *inter alia* such bodies are eligible for the membership of the Institute. Earlier, the Council had passed a resolution permitting chartered accountants from ICAEW to become members of the Institute (Appendix 6) as also fulfilment of certain conditions in respect of persons not permanently residing in India. However, the Council of the Institute at its meeting held in December, 1995 decided to withdraw the resolution w.e.f. December 8, 1995. In view of this, persons qualified from any of the four Institutes in the United Kingdom including England and Wales are not entitled to have their names entered in the Register of Members maintained by the Institute effective from December 8, 1995. Based on this development, partnership between members of the Institute and members of above foreign professional bodies will not be permissible from the above date. Even a chartered accountant from ICAEW who was eligible to become member of the Institute, the profit sharing arrangement stated in the question goes against the provisions of Clause 4. Hence, it would constitute professional misconduct.

Chartered Accountants practising outside India: A member of the Institute of Chartered Accountants of India practising outside India is not governed by the provisions of the Chartered Accountants Act, 1949 since the provisions of the said Act are not applicable outside India. Accordingly, the question of professional misconduct would not arise if an Indian chartered accountant practising outside India becomes a partner with aforesaid accountants and enters into partnership in that country with a member of the Institute of that country. There would be no professional misconduct within the provisions of the Institute of Chartered Accountants Act, 1949 as the applicability of such provisions does not extend to outside India.

(ii) (a) **Tax Consultant:** Section 7 of the Chartered Accountants Act, 1949 read with Clause (7) of Part I of the First Schedule to the said Act prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a chartered accountant in documents through which the professional attainments of the member would come to the notice of the public. Under the clause, use of any designation or expression other than chartered accountant for a chartered accountant in practice, on professional documents, visiting cards, etc. amounts to a misconduct unless it be a degree of a university or a title indicating membership of any other professional

body recognised by the Central Government or the Council. Thus, it is improper to use designation "Tax Consultant" since neither it is a degree of a University established by law in India or recognised by the Central Government nor it is a recognised professional membership by the Central Government or the Council.

(b) **Cost Accountant:** As stated in the preceding paragraph, this would also constitute misconduct under section 7 of the Act read with Clause (7) of Part I of the First Schedule to the Chartered Accountants Act, 1949. A chartered accountant in practice cannot use any other designation than that of a chartered accountant. Nevertheless, a member in practice may use any other letters or descriptions indicating membership of accountancy bodies which have been approved by the Council. Thus, it is improper for a chartered accountant to state in his documents that he is a "Cost Accountant". However as per Appendix 8 to the Chartered Accountants Act, 1949 the Council has resolved that the members are permitted to use letters indicating membership of the Institute of Cost and Works Accountants but not the designation "Cost Accountant".

Question 8

A partner of a firm of chartered accountants during a T.V. interview handed over a bio-data of his firm to the chairperson. Such bio-data detailed the standing of the international firm with which the firm was associated. It also detailed the achievements of the concerned partner and his recognition as an expert in the field of taxation in the country. The chairperson read out the said bio-data during the interview. Discuss whether this action by the Chartered Accountant would amount to misconduct or not.

Answer

Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits solicitation of client or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means since it shall constitute professional misconduct. The bio-data was handed over to the chairperson during the T.V. interview by the Chartered Accountant which included details about the firm and the achievements of the partner as an expert in the field of taxation. The chairperson simply read out the same in detail about association with the international firm as also the achievements of the partner and his recognition as an expert in the field of taxation. Such an act would definitely lead to the promotion of the firms' name and publicity thereof as well as of the partner and as such the handing over of bio-data cannot be approved. The partner would be held guilty of professional miscount under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

Question 9

Is there any misconduct on the part of a Chartered Accountant in the following circumstances?

(i) Mr. G, a Chartered Accountant in practice as a sole proprietor has an office in Mumbai near Church Gate. Due to increase in professional work, he opens another office in a suburb of Mumbai which is approximately 80 kilometers away from his existing office. For running the new office he employs three retired Income-tax Officers.

(ii) The offer document of a listed company in which Mr. D, a practising Chartered Accountant is a director mentions the name of Mr. D as a director along with his various professional attainments and spheres of specialisation.

Answer

(i) In terms of clause 1 of section 27 of the Chartered Accountants Act, 1949, if a chartered accountant in practice has more than one office in India, each one of these offices should be in the separate charge of a member of the Institute. There is however an exemption for the above if the second office is located in the same premises, in which the first office is located; or the second office is located in the same city, in which the first office is located; or the second office is located within a distance of 50 kms from the municipal limits of a city, in which the first office is located. Since the second office is situated beyond 50 kms of municipal limits of Mumbai city. Thus he would be liable for committing a professional mis-conduct.

(ii) The Council of the ICAI has in a communication to members stated that if a public company, in which a chartered accountant in practice is a director, issues a prospectus or gives any announcement that gives descriptions about the Chartered Accountant's expertise, specialisation and knowledge in any particular field, it shall constitute a violation of Clauses (6) and (7) of Part I of the First Schedule to the Chartered Accountants Act, 1949. The Council has further stated that in such cases the member concerned has to take necessary steps to ensure that such prospectus or public announcements or public communications do not advertise his professional attainments and also that such prospectus or public announcements or public communications do not directly or indirectly amount to solicitation of clients for professional work by the members. Thus in the instant case, Mr. D would be held to be guilty of professional mis-conduct and liable for disciplinary action.

Question 10

Discuss the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

(a) A Chartered Accountant in practice has been suspended from practice for a period of 6 months and he had surrendered his Certificate of Practice for the said period. During the said period of suspension, though the member did not undertake any audit assignments, he undertook representation assignments for income tax whereby he would appear before the tax authorities in his capacity as a Chartered Accountant.

(b) Mr. R, a Chartered Accountant in practice has been elected as the treasurer of a Regional Council of the Institute. The Regional Council had organized an international tour through a tour operator during the year for its members. During the audit of the Regional Council, it was found that Mr. R had received a personal benefit of ₹ 50,000 from the tour operator.

(c) Mr. Q a Chartered Accountant in practice as a proprietor died in a road accident. His widow sold the practice of her husband to another Chartered Accountant in practice for ₹ 5 lakhs. The price also included right to use the firm name of Mr. Q.

(d) M/s XYZ, a firm in practice, develops a website "xyz.com". The colour chosen for the website was a very bright green and the web-site was to run on a "push" technology where the names of the partners of the firm and the major clients were to be displayed on the web-site.

Answer

(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 practises 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: 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 Institute 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.

Question 11

Write a short note on - Maintenance of branch offices by Chartered Accountants in practice.

Answer

Maintenance of Branch Offices by Chartered Accountants in Practice: Section 27 of the Chartered Accountants Act, 1949 requires that if a chartered accountant in practice or a firm of chartered accountants has more than one office in India, i.e., a branch, each of such offices should be in the separate charge of a member of the Institute. Failure on the part of a member or a firm, to have a member in charge of its branch office and a separate member in case of the branches, if more than one, would constitute professional misconduct. However, exemption from the above has been given to members practising in the hilly areas subject to the certain conditions.

It is necessary to mention that the Chartered Accountant in charge of the branch of another firm should be associated with him or with the firm either as a partner or as a paid assistant. If he is a paid assistant, he must be in whole time employment with him. The above rule applies in case additional office is situated at a place beyond 50 Kms. from the municipal limits in which the office is situated.

The exemption may be granted under proviso to section 27(1) of the Chartered Accountants Act, 1949 to a member or a firm of Chartered Accountants in practice to have a second office without such second office being under the separate charge of a member of the Institute, provided (a) the second office is located in the same premises, in which the first office is located or (b) the second office is located in the same city, in which the first office is located or (c) the second office is located within a distance of 50 km. from the municipal limits of a city, in which the first office is located. A member having two offices of the type referred to above

shall have to declare, which of the two offices is his main office which would constitute his professional address.

Question 12

(a) Mr. X, a Chartered Accountant accepted his appointment as tax auditor of a firm under Section 44AB, of the Income-tax Act, and commenced the tax audit within two days of his appointment since the client was in a hurry to file Return of Income before the due date. After commencing the audit, Mr. X realised his mistake of accepting this tax audit without sending any communication to the previous tax auditor. In order to rectify his mistake, before signing the tax audit report, he sent a registered post to the previous auditor and obtained the postal acknowledgement. Will Mr. X be held guilty under the Chartered Accountants Act?

(b) Mr. J started his practice as Chartered Accountant in 2013. During 2014, he got an offer for the post of Chief Accountant of a Software Development Company, as a fulltime employee, for a salary of ₹ 60, 000 per month. On accepting this offer, Mr. J converted his practice into a partnership firm by taking a fresh Chartered Accountant as his partner. Mr. J neither intimated the Institute nor obtained permission from the Institute about his employment. Will Mr. J be held guilty under the Chartered Accountants Act?

(c) A Chartered Accountant in practice had confirmed in the application made by his articled clerk to the Council for permission to study that the normal working hours of his office were 11 a.m. to 6 p.m. and the hours during which the articled clerk was required to attend college classes were 7 a.m. to 9.30 a.m. On inquiry from Principal of College, it was ascertained that the articled clerk used to attend classes from 10 a.m. to 1.55 p.m. The Chartered Accountant pleaded ignorance about the articled clerk attending the college classes during office hours. Will the Chartered Accountant be held guilty of professional misconduct?

Answer

(a) Communication with the Previous Auditor: As per Clause 8 of Part I of First Schedule to the Chartered Accountants Act, 1949, Mr. X will be held guilty since he has accepted the tax audit, without first communicating with the previous auditor in writing. The object of the incoming auditor communicating in writing with the retiring auditor is to ascertain whether there are any circumstances which warrant him not to accept the appointment, for example, whether the previous auditor has been changed on account of having qualified the report or he had expressed a wish not to continue on account of something inherently wrong with the administration of the business. The retiring auditor may even give out information regarding the condition of the accounts of the client or the reason that impelled him to qualify his report. Under all circumstances, it would be essential for the incoming auditor to carefully consider the facts before deciding whether or not he should accept the audit. As a matter of professional courtesy and professional obligation it is necessary for the new auditor appointed to communicate with such earlier auditor.

The Code of Ethics further points out that it would also be a healthy practice if a tax auditor appointed for conducting special audit under the Income-tax Act, 1961 communicates even with the member who has conducted the statutory audit. Considering the above, though Mr. X tried to rectify his mistake, by communicating with the previous tax auditor after accepting the audit but before signing the audit report, the auditor will be held guilty of professional misconduct. Refer: Praful R.Gandhi of M/s Padamchand Jain & Associates councils decision dated 29th Aug 2005.

(b) Failure to take Permission before Accepting Employment: As per Clause 11 of Part I of First Schedule to the Chartered Accountants Act, 1949, Mr. J will be held guilty since he has accepted the full time salaried employment in addition to the practice of Chartered Accountancy without obtaining permission of the Institute. The Chartered Accountants Regulation, 1988 provide that a Chartered Accountant in practice shall not engage in any business or occupation other than the profession of accountancy except with the permission granted in accordance with the provisions contained in Regulation 190A. Part (B) of Appendix 10 to the Chartered Accountants Regulations, 1988 requires member of the Institute in practice to engage in full-time or part-time employment after obtaining the specific and prior approval of the Council. Further, Mr. J will be held guilty of professional misconduct under Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949 if contravenes any of the provisions of the Act since he has failed to inform the Institute.

(c) Failure to Observe the Regulations: As per Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949, a member shall be held guilty of professional misconduct if he contravenes any provision of the Act or the regulations made thereunder. The chartered accountant, as per Regulations also, is expected to impart proper practical training. In the instant case, the articled clerk must have not been attending office on a regular basis and the explanation of the Chartered Accountant cannot be accepted particularly in view of the fact that the chartered accountant did not obtain certificate from the Principal to confirm the timings. It is also quite likely that the articled clerk would be availing leave quite often and coming late to the office. Under the circumstances, the Chartered Accountant is guilty of professional misconduct in regard to the discharge of his professional duties.

Question 13

Can a Practicing Chartered Accountant be held guilty of Professional Misconduct under the following circumstances? Give your views with reasons in brief.

(a) Z, a Chartered Accountant wrote several letters to Government Department, pointing out seniority of his firm, sending his life sketch and stating that he had a glorious record of service to the country as well as to the organization of accountancy profession with a view to get the audit work.

(b) W, a Chartered Accountant has sent letters under certificate of posting to the previous auditor informing him his appointment as an auditor before the commencement of audit by him.

(c) The Cashier of a company committed a fraud and absconded with the proceeds thereof. This happened during the course of the accounting year. The Chief Accountant of the company also did not know about fraud.

In the course of the audit, at the end of the year, the auditor failed to discover the fraud. After the audit was completed, however, the fraud was discovered by the Chief Accountant. Investigation made at that time indicates that the auditor did not exercise proper skill and car and performed his work in a desultory and haphazard manner. With this background, the Directors of the company intend to file disciplinary proceedings against the auditor.

Discuss the position of the auditor with regard to the disciplinary proceedings.

Answer

(a) Solicitation of Professional Work Through Letters: 'Z' a chartered accountant, wrote several letters to Government Department pointing out the seniority of his firm and sending his life sketch and stating that he had rendered glorious service to the country and to the accountancy profession with a view to getting the audit work. Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949 prohibits a member not to solicit professional work by means of advertisement, circular, personal communication or interview or by any other means. Since these letters were clearly in the nature of advertising professional attainments, "Z" was guilty of professional misconduct under clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949.

(b) Communication with the Previous Auditor: Clause 8 of Part I of the First Schedule to the Chartered Accountants Act, 1949 requires communication by the incoming auditor with the previous auditor before accepting a position by him. The Council of the Institute has taken the view that a mere posting of a letter "under certificate of posting" is not sufficient to establish communication with the retiring auditor unless there is some evidence to show that the letter has in fact reached the person communicated with. A Chartered Accountant who relies solely upon a letter posted "under certificate of posting" therefore does so at his own risk. Since the letters were sent by "W" to the previous auditor informing him of his appointment as an auditor before the commencement of audit by him under Certificate of Posting is not sufficient to prove communication with the retiring auditor. In the opinion of the Council, communication by a letter sent "Registered Acknowledgement Due" or by hand against a written acknowledgement would in the normal course provide positive evidence. Hence "W" was guilty of professional misconduct under Clause (8) of Part I of First Schedule to the Chartered Accountants Act, 1949.

(c) Failure to Exercise Reasonable Care and Skill: Apparently, as it appears from the facts of the case that the auditor did not exercise proper skill and care and that he performed his work in a desultory and haphazard manner. In this matter, the test for auditor's liability lies in whether he has applied reasonable care, skill and caution called for in the circumstances of the case and whether he reasonably used all the information that he came across in the course of audit. Cash is a very significant item in any situation and the fact that the cashier had left during the year without notice should have placed the auditor on alert as regards the cash book. In fact, the very fact that the cashier was absconding, i.e., left without any notice constituted sufficient circumstances to excite suspicion of the auditor to probe to the bottom. As per SA 240, "The auditor's responsibilities relating to fraud in an audit of financial statements", it can be concluded that the auditor did not plan and perform the audit with an attitude of professional skepticism. Thus, having regard to this and a fraud has actually taken place during the year, committed by the absconding cashier, it is reasonable to think that prima facie there is a case against the auditor for gross negligence. Clause (7) of Part I of Second Schedule to the Chartered Accountants Act, 1949 requires that it is the duty of an auditor to bring to bear in the work he has to perform that skill, care and caution as per the circumstances in an honest and reasonable manner. As it appears from the facts of the case, the auditor has been grossly negligent in performing his duties which constitutes professional misconduct. Thus, such instances require reference to Disciplinary Committee of the Council of the Institute. If a member is found guilty by the Council of any of the acts or omissions stated in the Schedule, its finding with recommendations are to be referred to the High Court for decision.

Question 14

(a) A chartered accountant holding certificate of practice and having four articled clerks registered under him accepts appointment as a full-time lecturer in a college. Also he becomes a partner with his brother in a business. Examine his conduct in the light of Chartered Accountants Act, 1949 and the regulations thereunder.

(b) XYZ Co. Ltd. has applied to a bank for loan facilities. The bank on studying the financial statements of the company notices that you are the auditor and requests you to call at the bank for a discussion. In the course of discussions, the bank asks for your opinion regarding the company and also asks for detailed information regarding a few items in the financial statements. The information is available in your working paper file. What should be your response and why?

(c) A chartered accountant in practice, in spite of repeated requests from the Secretary of the Institute fails to submit form 18. Is he liable for misconduct?

Answer

(a) Clause (11) of Part I of the First Schedule to the Chartered Accountants Act, 1949 debars a chartered accountant in practice from engaging in any business or occupation other than the profession of chartered accountancy unless permitted by the Council of the Institute so to engage. This clause, in effect, has empowered the Council of the Institute to permit chartered accountants in practice to engage in any other business or occupation considered fit and proper. Accordingly, the Council had formulated Regulations 190A and 191 to the Chartered Accountants Regulations, 1988 to provide a basis for considering applications of chartered accountants seeking permission to engage in other business or occupation. A member can accept full- time lecturer-ship in a college only after obtaining the specific and prior approval of the Council. As also

becoming a partner in a business with his brother would require specific permission the chartered accountant is liable for professional misconduct since he failed to obtain specific and prior approval of the Council in each case.

(b) Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 states that a chartered accountant in practice shall be deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of the client or otherwise than as required by law for the time being in force. SA 200 on " Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" also reiterates that, "the auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose". In the instant case, the bank has asked the auditor for detailed information regarding few items in the financial statements available in his working papers. Having regard to the position stated earlier, the auditor cannot disclose the information in his possession without specific permission of the client. As far as working papers are concerned, working papers are the property of the auditor. The auditor may at his discretion, make portions of or extracts from his working papers available to his client". Thus, there is no requirement compelling the auditor to divulge information obtained in the course of audit and included in the working papers to any outside agency except as and when required by any law.

(c) Clause (2) of Part III of the First Schedule requires a member to supply the information called for by the Council or any of its Committees and Clause (1) of Part II of the Second Schedule requires every member of the Institute to act within the framework of the Chartered Accountants Act and the Regulation made thereunder. Under the former clause, it is misconduct for chartered accountants generally, if they do not supply the information called for by the Council. The Secretary acts for the Council; hence, request from the Secretary amounts to a request from the Council. Besides, it is also a contravention of Regulation of the Chartered Accountants Regulations, 1988. Thus, failure to submit Form 18 (deals with Deed of Assignment of Articles where the Articled Clerk is a minor) constitutes professional misconduct.

Question 15

Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules there to:

(a) CA X was appointed as the Auditor of ABC Ltd. for 2013-14. Since he declined to accept the appointment, the Board of Directors appointed CA Y as the auditor in the place of CA X, which was also accepted by CA Y.

(b) CA Z who is a leading Income Tax Practitioner and consultant in Jaipur is also trading in derivatives.

(c) CA D, a Chartered Accountant prepared a project report for one of his clients to obtain bank finance (long-term) of ₹ 50 lakhs from a Commercial Bank. Consequent to the sanction of the loan by the bank CA D raised a bill for his services @ 2% of the loan sanctioned.

(d) CA ZZ who conducted ABC audit of a marathi daily 'New Era' certified the circulation figures based on Management Information System Report (M.I.S Report) without examining the books of Account.

Answer

(a) ***Clause (9) of Part I of the First Schedule to the 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 (now Section 139 and 140 read with Section 141 of the Companies Act, 2013), in respect of such appointment have been duly complied with.***

Board can appoint the auditor in the case of casual vacancy under Sections 139(8)(i) and Section 139(6) of the Companies Act, 2013. The non-acceptance of appointment by CA. X does not constitute a casual vacancy to be filled by the Board. In this case, it will be deemed that no auditor was appointed in the AGM.

Further, as per Section 139(10) of the Companies Act, 2013 when at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company. The appointment of the auditor by the Board is defective in law.

Hence CA. Y is guilty of professional misconduct as per clause 9 of the First Schedule as he accepted the appointment without verification of statutory requirements.

(b) As per clause 11 of Part-I of First Schedule of the Chartered Accountants Act, 1949 (hereinafter referred as 'Act'), a Chartered Accountant 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 so to engage".

However, the Council has granted general permission to the members to engage in 12 specific occupation. In respect of all other occupations specific permission of the Institute is necessary.

In this case, CA Z is engaged in the occupation of trading in derivatives which is not covered under the general permission.

Hence specific permission of the Institute has to be obtained otherwise he will be deemed to be guilty of professional misconduct under clause 11 of Part-I of First Schedule of the Act.

(c) Clause 10 of part I to First Schedule to the Chartered Accountants Act prohibits a Chartered Accountant in practice to charge, to offer, to accept or accept fees which are based on a percentage of profits or which are contingent upon the findings or results of such work done by him.

However, this restriction is not applicable where such payment is permitted by the Chartered Accountants Act, 1949. The Council of the Institute has framed regulation 192 which exempts certain professional services from the operation of clause 10.

The services rendered by CA. D are not covered under the said exemption and hence CA. D is liable for professional misconduct.

(d) According to clause 7 of Part-I of Second Schedule of Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he "does not exercise due diligence or is grossly negligent in the conduct of his professional duties".

In the instant case, CA ZZ did not exercise due diligence and is grossly negligent in the conduct of his professional duties since he certified the circulation figures without examining the books of accounts.

To ascertain the number of paid copies verification of remittances from the agents, credit allowed to the agents for unsold copies returned, examination of books of account is essential.

Further certification of circulation figures based on statistical information without cross verification with financial records amounts to gross negligence and failure to exercise due diligence.

Hence, CA ZZ is guilty of professional misconduct as per clause 7 of part I of Second Schedule of Chartered Accountants Act, 1949.

Question 16

Comment on the following with reference to the Chartered Accountants Act, 1949 as amended by the Chartered Accountants (Amendment) Act, 2006 and schedules thereto:

(a) As a Chartered Accountant in practice, you are asked to conduct a review of the "Profit Forecast" prepared by a Company in connection with its application for a Term loans from a bank.

(b) X, a Chartered Accountant availed a loan against his shares held as investments from a nationalized bank. He issued 2 cheques towards repayment of the said loan. Both the cheques were returned back by the bank with the remarks "Refer to Drawer".

(c) BC & Co, a firm of Chartered Accountants, accepted an assignment for audit under State level VAT Act, without any prior communication with the previous auditor.

(d) M, a Chartered Accountant in practice, is the Statutory Auditor of S Ltd. for the year ended 31st March 2014. In January 2014, he was appointed as a Director in H Ltd., which is the holding Company of S Ltd.

Answer

(a) Under Clause 3 of Part I of Second Schedule to The Chartered Accountants Act, 1949, a CA in practice is deemed to be guilty of professional misconduct if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast. "The guidance note on accountants' report on profit/financial forecast" provides that profit forecasts can be prepared or reviewed by a CA provided he discloses in his report the sources of information, the basis of forecasts and major assumptions involved and so long as he does not vouch for the accuracy of the forecast. Hence, the offer can be accepted if the above guidance note is complied with.

(b) A Chartered Accountant is expected to maintain the highest standard 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.

A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, if he is found guilty of any professional or "Other Misconduct".

As per Clause 2 of Part IV of the First Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be 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 his professional work.

The question whether a particular act or omission constitutes "other misconduct" should be based on fact and circumstances of each case.

Under Negotiable Instruments Act 1881, where any cheque drawn by a person for the discharge of any liability is returned by the bank unpaid, either for insufficiency of funds or the cheque amount exceeds the arrangements made by the drawer of the cheque, the drawer of such cheque shall be deemed to have committed an offence.

In the given case the cheque was dishonoured with the remark "refer to drawer". However, such dishonour need not necessarily be only due to insufficiency of funds.

If it is proved that the cheques were dishonoured due to insufficiency of funds, the CA would be held guilty of "other misconduct".

(c) As per Clause 8 of Part I of First Schedule to the CA Act 1949, a chartered accountant in practice is deemed to be guilty of professional misconduct if he accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been issued certificate under the Restricted Certificates Rules 1932, without first communicating with him in writing.

In the instant case, BC & Co. accepted VAT – audit under State Level Act, carried out by another firm of chartered accountants in the previous year, without prior communication with the previous auditor.

A communication is mandatory requirement for all types of audit, if the previous auditor is a chartered accountant. Hence, the firm is guilty of professional misconduct.

(d) In terms of clause 11 of Part I of the First Schedule to the CA Act, 1949, a CA in practice cannot engage (unless permitted by the council) in any business or occupation other than the profession of Chartered accountant, but he can be a director of a company wherein he or any of his partners is not interested in such company as auditor.

However, public conscience is expected to be ahead of law and the requirement of independence should be interpreted much more strictly. Members should thus not place themselves in position which would either compromise or jeopardise their independence.

In view of the above, an auditor of a subsidiary cannot be a director of a holding company as it will affect his independence.

Question 17

Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

(a) Mr. A, a practicing Chartered Accountant agreed to select and recruit personnel, conduct training programmes for and on behalf of a client.

(b) XY & Co., a firm of Chartered Accountant having 2 partners X & Y, one in charge of Head Office and another in charge of Branch at a distance of 80 kms, puts up a name-board of the firm in both premises and also in their respective residences.

(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.

Answer

(a) Under Section 2(2)(iv) of the Chartered Accountants Act, 1949, a member of the Institute shall be deemed "to be in practice" when individually or in partnership with Chartered Accountants in practice, he, in consideration of remuneration received or to be received renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice. Pursuant to Section 2(2)(iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services".

The definition of the expression "Management Consultancy and other Services" includes Personnel recruitment and selection. Personnel Recruitment and selection includes, development of human resources including designing and conduct of training programmes, work study, job description, job evaluation and evaluations of work loads.

So A is not guilty of professional misconduct.

(b) The council of the Institute has decided that with regard to the use of the name-board, there will be no bar to the putting up of a name-board in the place of residence of a member with the designation of chartered accountant, provided, it is a name-plate or board of an individual member and not of the firm. In the given case partners of X Y & Co., put up a name board of the firm in both offices and also in their respective residences.

Thus the chartered accountants are guilty of misconduct. Distance given in the question is not relevant for deciding.

(c) As per clause 5 of Part I of Second Schedule of the Chartered Accountant Act, 1949, 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, 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.

Question 18

Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

(a) A chartered accountant in practice created his own website in attractive format and colours and circulated the information contained in the website through E-mail.

(b) A chartered accountant in practice takes up the appointment as managing director of a public limited company.

(c) S. a practicing chartered accountant gives power of attorney to an employee chartered accountant to sign reports and financial statements, on his behalf.

(d) A is the auditor of Z Ltd., which has a turnover of ₹200 crore. The audit fee for the year is fixed at ₹50 lakhs. During the year, the company offers A an assignment of management consultancy within the meaning of Section 2(2)(iv) of the CA Act, 1949 for a remuneration of ₹1 crore. A seeks your advice on accepting the assignment.

Answer

(a) Creation of own website by a chartered accountant/firm of chartered accountants The guidelines approved by the Council of the Institute of Chartered Accountants of India permits creation of own website by a chartered accountant in his or his firm name and no standard format or restriction on colours is there. The chartered accountant or firm, as per the guidelines, should ensure that none of the information contained in the website be circulated on their own or through E-mail or by any other mode except on a specific "Pull" request.

Since in the given case, the chartered accountant circulated the information contained in the website through E-mail, he is guilty of misconduct under clause 6 of Part I of the First Schedule to the Chartered Accountants Act, i.e., a chartered accountant in practice is deemed to be guilty of professional misconduct if he solicits client or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means.

(b) Appointment of a Chartered Accountant in practice as MD of a Public Limited Company: 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.

(c) Power of signing reports and financial statements: Under clause 12 of Part I of First Schedule to the Chartered Accountants Act, 1949, 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.

(d) Appointment as a statutory auditor of a PSUs'/Govt company(ies)/listed company(ies) and other public company(ies): As per the Council General Guidelines 2008, under Chapter IX on appointment as statutory auditor a member of the Institute in practice shall not accepts the appointment as a statutory auditor of a PSUs'/Govt company(ies)/Listed company(ies) and other public company(ies) having a turnover of ₹ 50 crores or more in a year and where he accepts any other work(s) or assignment(s) or service(s) in regard to same undertaking(s) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same undertaking. For this purpose the other work/services includes Management Consultancy and all other professional services permitted by Council excluding audit under any other statute, Certification work required to be done by the statutory auditor and any representation before an authority.

In view of the above position it would be a misconduct on A's part if he accepts the management consultancy assignment for a fee of ₹ 1 crore.

Question 19

Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

*(a) **Mr. Rahul, a locally based Chartered Accountant, accepted an audit assignment at a fee lower than that charged by the previous auditor, who was stationed in another town and had to spend a lot of money on travel for which he did not charge separately.***

(b) The superannuation-cum-pension fund for the employees of a company was under a separate 'trust'. Both the company and the trust were under the same management. The auditor, who was auditing the accounts of the company as well as the trust noted some irregularities in the operation of the trust and commented upon these irregularities in the confidential report given to the trustees, but did not mention about these irregularities in his report on the Annual accounts of the Trust.

(c) *M/s XYZ a firm of Chartered Accountants received ₹2 lakhs in January, 2014 on behalf of one of their clients, who has gone abroad and deposited the amount in their Bank account, so that they can return the money to the client in July, 2014, when he is due to return to India.*

(d) *Mr. J.J. a practicing Chartered Accountant engages himself as part time finance manager of Quick Return Securities Ltd. He is of the view that as both functions are independent, he need not take permission from the Institute.*

Answer

(a) ***Undercutting of fees: In this case, Mr. Rahul is a locally based Chartered Accountant, accepted an audit assignment at a fee lower than that charged by the previous auditor, who was outstation based Chartered Accountant and had to spend a lot of money on travel which was included in his audit fee and was not charged by him separately. The motive of Mr. Rahul was not to get the work from previous auditor by accepting the audit assignment on lower fee i.e. undercutting of fee. Because, in considering whether variation in fees charged would constitute undercutting, the quantum of work; incidental and out of pocket expenses and other terms of appointment should be considered.***

Since the previous auditor was stationed in another town and therefore, had to incur higher cost on account of conveyance, and the previously the fee was decided on a composite basis inclusive of travelling expenses of the auditor, it cannot be said that Mr. Rahul has accepted an audit assignment based on under cutting of fees. Hence, Mr. Rahul will not be held guilty for misconduct.

(b) **Disclosure of material facts:** A Chartered Accountant in practice is deemed to be guilty of professional misconduct under clause 5 of Part I of the Second Schedule if he "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". In this case, the Chartered Accountant was aware of the contraventions and irregularities committed by the trust as these were referred to in the confidential report given by the Chartered Accountant to the trustees of the company. However, he had issued the annual accounts without any qualification. On similar facts it was held by the Supreme Court in Kishorilal Dutta vs. P. K. Mukherjee that it was the duty of the Chartered Accountant to have disclosed the irregularities and contravention to the beneficiaries of the fund in the statement of accounts signed by him. Accordingly, in the present case also it has to be held that the Chartered Accountant is guilty of professional misconduct if the amount of irregularities is proved material.

(c) **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".

XYZ received the money in January, 2014 which is to be paid only in July 2014; hence it should be deposited in a separate bank account. Since in this case XYZ have failed to keep the sum of ₹ 2 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.

(d) **Engaging in any business other than the profession of Chartered Accountants:** Clause 11 of Part I of First Schedule of Chartered Accountants Act, 1949 states that a Chartered Accountant is deemed to be guilty of professional misconduct if he engages in any business other than the profession of Chartered Accountant unless permitted by the Council for the same.

In the given case Mr. J. J. a practicing Chartered Accountant is engaging himself as part time Finance Manager without the permission of the Institute which is misconduct attracted by clause II of Part I of First Schedule.

Question 20

Comment on the following with reference to the Chartered Accountants Act, 1949, Code of Ethics and Schedules to the Act:

(a) *P, a Chartered Accountant in practice provides management consultancy and other services to his clients. During 2014, looking to the growing needs of his clients to invest in the stock markets, he also advised them on Portfolio Management Services whereby he managed portfolios of some of his clients.*

(b) *B, a Chartered Accountant in practice is a partner in 3 firms. While printing his personal letter heads, B gave the names of all the firms in which he is a partner.*

(c) *XYZ & Associates, a firm with 5 partners developed a website www.xyzassociates.com. The website also contained a link to "All India Chartered Accountants Association", a voluntary association where X, a partner of the firm is currently the Vice-president.*

(d) *M/s LMN, a firm of Chartered Accountants responded to a tender from a State Government for computerization of land revenue records. For this purpose, the firm also paid ₹ 50,000 as earnest deposit as part of the terms of the tender.*

Answer

(a) **Advising on Portfolio Management Services:** The Council of the Institute of Chartered Accountants of India (ICAI) pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 has passed a resolution permitting "Management Consultancy and other Services" by a Chartered Accountant in practice. A clause of the aforesaid resolution allows Chartered Accountants in practice to act as advisor or consultant to an issue of securities including such matters as drafting of prospectus, filing of documents with SEBI, preparation of publicity budgets, advice regarding selection of brokers, etc. It is, however, specifically stated that Chartered Accountants in practice are not permitted to undertake the activities of broking, underwriting and portfolio management Services. Thus, a chartered accountant in practice is not permitted to manage portfolios of his clients.

In view of this, P would be guilty of misconduct under the Chartered Accountants Act, 1949.

(b) Advertisement of Professional Attainments: Clause 7 of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public. Even a member is not permitted to specify the date of setting up of practice or establishment of firm. However, there is no prohibition for printing names of all the three firms on the personal letterheads in which a member holding Certificate of Practice is a partner. Thus B is not guilty of any misconduct under the Chartered Accountants Act, 1949.

(c) Developing Website: As per the guidelines laid down under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 in respect of websites by chartered accountants in practice, it is permitted that website may provide a link to the website of ICAI, its Regional Councils, Branches and Government Departments and other professional Bodies like AICPA, ICAEW, CICA. In this case, M/s XYZ Associates provided a link to "All India Chartered Accountants Association" which is not permitted. Hence the firm would be liable for misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(d) 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 LMN can respond to tender as well as deposit ₹ 50,000 as earnest deposit and shall not have committed any professional misconduct.

Question 21

Comment with reference to the Chartered Accountants Act, 1949 and Schedules thereto:

(a) H, a Chartered Accountant in practice is a partner in 3 firms. On the personal Letter Heads of H, names/address of all the 3 firms are mentioned.

(b) D, who conducts the tax audit u/s 44AB of the Income Tax Act, 1961 of M/s ABC, a partnership firm, has received the entire audit fees of ₹ 25,000 in April, 2014 in respect of the tax audit for the year ended 31.3.2014. The audit report was, however, signed on 25.5.2014.

*(c) **M/s LMN, a firm of Chartered Accountants having 5 partners accepts an audit assignment of a newly formed private limited company for audit fees of ₹ 5,000.***

(d) P, a Chartered Accountant in practice, accepts appointment as statutory auditor for LMN Pvt. Ltd. Q, brother of P has substantial interest in LMN Pvt. Ltd.

Answer

(a) Under clause (7) of part -1 of First Schedule, a CA in practice is deemed to be guilty of professional misconduct if he (i) advertises his professional attainments or services or (ii) uses any designation or expressions other than 'Chartered Accountant" on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a university established by law in India or recognized by the Central Government or a title indicating membership of the ICAI or of any other institution that has been recognized by the Central Government or may be recognized by the council.

Here there is no prohibition for printing names of all 3 firms on the personal letter heads in which a member holding certificate of practice is a partner. Thus, H is not guilty of any professional misconduct in the above case.

(b) ***As per Section 141(3)(d)(ii) of the Companies Act, 2013, a person who, or his relative or partner is indebted to the company, or its subsidiary, or its holding or associate company, or a subsidiary of its holding company, for an amount exceeding ₹ 5,00,000 then he is not qualified for appointment as an auditor of a company.***

In the instant Case, D is appointed to conduct a tax audit u/s 44AB of the Income Tax Act, 1961. There is no such similar provisions in the Income Tax Act. Thus, D will still be able to do the audit and would not be disqualified. He also does not violate any provision of the CA Act, 1949 and schedules thereto.

(c) ***Prescribed minimum audit fee is recommendatory, not mandatory in nature. Therefore, acceptance of audit assignment by M/s LMN, a firm of Chartered Accountants having 5 partners of a newly formed private limited company for audit fees of ₹ 5,000 is not violation of any provisions.***

Therefore M/s LMN will not be held liable for guilty of misconduct.

(d) As per clause (4) of part I of Second Schedule, a CA is deemed to be guilty of professional misconduct if he expresses his opinion on financial statements in which his firm or a partner has substantial interest. As per Council General Guidelines, 2008, the above restriction is also made applicable for relatives of the members.

Further, as per Section 141(3)(f) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor of a company whose relative is a director or is in the employment of the company as a director or key managerial personnel.

In the instant Case, since Q, a relative has a substantial interest in LMN Pvt. Ltd., P cannot conduct the audit and needs to vacate the office. Thus Q will be guilty of misconduct in terms of above clause.

Question 22

Loans were given out of the funds of an Employees Provident Fund to the employer company in contravention of the applicable rules. As the auditor of the said Provident Fund, M discloses the contraventions to the Trustees of the fund, but failed to do so to the members of the fund. Comment.

Answer

As per clause 5 of Part I of Second Schedule to the Chartered Accountants Act, 1949, 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).

Further, 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 the given Case, CA M has contravened clause (5) of part I of Second Schedule as it is the duty of a CA in practice to disclose material facts known to him so that the financial statement does not become misleading.

Further the auditor CA should disclose such facts to beneficiaries of a fund in applicable cases. Technically, appointment of an auditor could be done by a company through its directors, but in substance the auditor in such cases addresses to the beneficiaries just like he gives his report to the shareholders of a company.

Therefore, in the instant case Mr. M is found guilty of professional misconduct.

Question 23

Give your comments with reference to the Chartered Accountants Act, and Schedules thereto:

(a) Mr. A, a practicing Chartered Accountant, took over as the executive chairman of Software Company on 1.4.2014. On 10.4.2014 he applied to the Council for permission.

(b) Mr. X, a practicing Chartered Accountant, issued a circulation certificate for a periodical on the basis of outward memos, which was later found to be false.

(c) Mr. Z, a practicing Chartered Accountant, received a sum of ₹ 1 lac on 1.9.2013 from a Client who intends to leave abroad for a period of a year, with a request that his advance tax liabilities to be paid over the three instalments. On 15th September, 2013, 15th December, 2013 and 15th March, 2014. After remitting the 1st instalment of advance tax on 15.9.2013, Z did not keep the Balance Money in a separate Bank account and he is of the opinion he will remit the money within reasonable time as per payment schedule of Advance tax.

(d) Mr. X, a Chartered Accountant, employed as a paid Assistant with a Chartered Accountant firm. On 31st December, 2013 he leaves the services of the firm. Despite many reminders from ICAI he fails to reply regarding the date of leaving the services of the firm.

Answer

(a) Specific Permission to be obtained: As per Clause (11) of Part I of First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice will be 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 so to engage.

In the instant case, Mr. A took over as the executive chairman on 01.04.2014 and applied for permission on 10.04.2014. On the basis of these facts, he was engaged in other occupation between the period 01.04.2014 and 10.04.2014, without the permission of the Council and therefore, Mr. A is guilty of professional misconduct in terms of Clause (11) of Part I of First Schedule of the Chartered Accountants Act, 1949.

(b) Failure to obtain information: As per Clause (8) of Part I of Second Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice, will be deemed to be guilty of professional misconduct if he fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion.

This indicates a Chartered Accountant must determine the extent of information, which, should be obtained by him before he expresses an opinion on the financial statements.

In the present case, Mr. X certifies the circulation based on outward memos, without going into the most elementary details of how the circulation of a periodical was maintained, i.e. not verifying the financial records, bank statements, collections for the periodicals, payment of the printer's bills etc. Hence, he is guilty of professional misconduct as per Clause (8) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

(c) Money of client to be kept in separate bank account: As per Clause (10) of Part I of Second Schedule to the Chartered Accountant Act, 1949, a Chartered Accountant in practice will be deemed to be guilty of professional misconduct if he fails to keep moneys of his client other than the fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.

The term reasonable time would depend upon the circumstances of the case. Moneys which are intended to be spent within a reasonably short time need not be put in a separate bank account.

Thus, in the instant case, Mr. Z should have kept the balance money after remitting the first instalment of advance tax into a separate bank account. Hence he is guilty of professional misconduct as per Clause (10) of Part I of Second Schedule of the Chartered Accountants Act, 1949.

(d) Failed to supply information called for: As per Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949, a member, whether in practice or not, will be deemed to be guilty of professional misconduct if he does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate authority.

Thus, in the given case, Mr. X has failed to reply to the letters of the Institute asking him to confirm the date of leaving the service as a paid assistant. Therefore, he is held guilty of professional misconduct as per Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949.

Question 24

Give your comments with reference to the Chartered Accountants Act, and schedules thereto:

(a) Mrs. Fair is a Director of XYZ Private Limited, having 15% share-holdings in the company. During 2013, the company appointed C.A. Mr. Lovely, Mrs. Fair's spouse, as its statutory auditor. On Mr. Lovely's advice, the company issued fresh equity shares in 2013-14, in the ratio of one share for every two shares held by the shareholders of the company. Mr. Lovely used to deliver audit report for subsequent years without any comments or disclosures, thereupon.

(b) Mr. A, a Chartered Accountant was the auditor of 'A Limited'. During the financial year 2013-14, the investment appeared in the Balance Sheet of the company of ₹10 lakhs and was the same amount as in the last year. Later on, it was found that the company's investments were only ₹ 25,000, but the value of investments was inflated for the purpose of obtaining higher amount of Bank loan.

(c) An advertisement was published in a Newspaper containing the photograph of Mr. X, a member of the institute wherein he was congratulated on the occasion of the opening ceremony of his office.

(d) Mr. X, a Chartered Accountant and the proprietor of X & Co., wrote several letters to the Assistant Registrar of Co-operative Societies stating that though his firm was on the panel of auditors, no audit work was allotted to the firm and further requested him to look into the matter.

Answer

(a) ***Clause (9) of Part I of the First Schedule to the 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 (now Section 139 and 140 read with Section 141 of the Companies Act, 2013), in respect of such appointment have been duly complied with.***

As per Section 141(3)(f) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor of a company whose relative is a director or is in the employment of the company as a director or key managerial personnel. The definition of 'Relative' includes husband and wife.

In this case Mrs. Fair is a Director of XYZ Private Limited and the company has appointed Mr. Lovely, Chartered Accountant, Mrs. Fair's spouse, as its statutory auditor. Mr. Lovely should not accept the appointment as statutory auditor of the company, where his wife Mrs. Fair is director. This is contravention of section 141 (3) (f) of the Companies Act, 2013.

Therefore, Mr. Lovely is liable for misconduct as per Clause (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(b) As per Part I of Second Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he, certifies or submits in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another chartered accountant in practice, under Clause (2); does not exercise due diligence, or is grossly negligent in the conduct of his professional duties, under Clause (7); or fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion, under Clause (8).

The primary duty of physical verification and valuation of investments is of the management. However, the auditor's duty is also to verify the physical existence and valuation of investments placed, at least on the last day of the accounting year. The auditor should verify the documentary evidence for the cost/value and physical existence of the investments at the end of the year. He should not blindly rely upon the Management's representation.

In the instant case, such non-verification happened for two years. It also appears that auditors failed to confirm the value of investments from any proper source. In case auditor has simply relied on the management's representation, the auditor has failed to perform his duty.

Accordingly, Mr. A, will be held liable for professional misconduct under Clauses (2), (7) and (8) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

(c) As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means.

In the given case, Mr. X published an advertisement in a Newspaper containing his photograph on the occasion of the opening ceremony of his office. On this context, it may be noted that the advertisement which had been put in by the member is quite prominent. If soliciting of work is allowed, the independence and forthrightness of a Chartered Accountant in the discharge of duties cannot be maintained.

The above therefore amounts to soliciting professional work by advertisement directly or indirectly. Mr. X would be therefore held guilty under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(d) As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means.

In the given case, Mr. X, a Chartered Accountant and proprietor of M/s X and Co., wrote several letters to the Assistant Registrar of Co-operative Societies, requesting for allotment of audit work. In similar cases, it was held that the Chartered Accountant would be guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949. The writing of continuous letter to ascertain the

reasons for not getting the work is quite alright but in case such either amount to request for allowing the work then Mr. X will be liable for professional misconduct.

Consequently, Mr. X would therefore be held guilty under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

Question 25

Give your comments with reference to the Chartered Accountants Act, 1949 and schedules thereto:

(a) PQR and Associates, Chartered Accountants have their website and on the letterhead of the firm it is mentioned that "Visit our website: PQR com". In the website the nature of assignments handled, names of prominent clients and fees charged is also displayed.

(b) Mr. B is a practising Chartered Accountant holding a valid certificate of practice. He accepted the appointment as Director of the Green World Co. Ltd. Mr. C, a partner of Mr. B is statutory auditor of the said company.

(c) YKS & Co., a proprietary firm of Chartered Accountants was appointed as concurrent auditor of a bank. YKS used his influence for getting some cheques purchased and thereafter failed to repay the loan/overdraft.

(d) Mr. Mohan is a practising Chartered Accountant. He issued a certificate of consumption which did not reflect the correct factual position of the consumption of raw material by the concerned entity. It is found that the certificate is given on the basis of data appearing in the minutes of meeting of the Board of Directors.

Answer

(a) The Council of the Institute of Chartered Accountants has issued guidelines for posting the particulars on Website by Chartered Accountants in practice and firms of Chartered Accountants in practice under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949. According to the guidelines the details in the website should be so designed that it does not amount to soliciting client or professional work. It is permitted to mention the website address on letterhead but soliciting people to visit website is not permitted. PQR and Associates letterhead invites to people to visit their website. Similarly the website mentions the nature of assignments, names of the prominent clients and fees charged. The nature of assignments is permitted for display only on specific 'Pull" request. And the name of clients, the fees charged is not permitted at all.

PQR & Associates will be held guilty of Professional Misconduct under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949.

(b) Clause 11 of Part 1 of First Schedule to the Chartered Accountants Act, 1949 prohibits a member to engage in any business or occupation other than the profession of chartered accountants unless permitted by the Council so to engage. It does not prohibit a Chartered Accountant from being a director of a company, except managing director or a whole time director. But if any of the partners is interested in such company as an auditor then he cannot be director of the said company. In the present case Mr. B has accepted the directorship in a Company where his partner Mr. C is an auditor without obtaining specific permission of the council. Hence, Mr. B will be held guilty for professional misconduct under Clause (11) of Part 1 of First Schedule to the Chartered Accountants Act, 1949.

Further, the Council of the Institute of Chartered Accountants of India has categorically stated that in cases where a member is a director of a company, the firm, in which the said member is a partner, should not express any opinion on its financial statements. Clause (4) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 states that expressing an opinion on financial statement of any business establishment in which the auditor, his firm or a partner of his firm has a substantial interest would constitute misconduct.

Additionally, Section 141(3)(c) of the Companies Act, 2013 also disqualifies a person to be appointed as an auditor if he is a partner of an officer of the company. Furthermore, section 141(4) of the Companies Act, 2013 requires the appointed auditor to vacate his office if he incurs any of the disqualifications mentioned under sub-section (3).

Therefore, in cases, where a member of the Institute is a director of a company or a firm in which said member is a partner should not express any opinion on its financial statements. Hence Mr. C, a partner of Mr. B, should vacate the office.

(c) This is a case which is covered under the expression in other misconduct of the Chartered Accountants Act, 1949. As per Clause (2) of Part IV of First Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be 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 his professional work. Here the Chartered Accountant is expected to maintain the highest standards and integrity even in his personal affairs and any deviation from these standards calls for disciplinary action.

In the present case, YKS & Co, being a concurrent auditor used his position to obtain the funds and failed to repay the same to the bank. This brings disrepute to the profession of a Chartered Accountant. This act of YKS & Co is not pardonable.

Therefore, YKS & Co will be held guilty of other misconduct under Clause (2) of Part IV of First Schedule to the Chartered Accountants Act, 1949.

(d) According to Clause 2 of Part 1 of Second Schedule to the Chartered Accountants Act, 1949 a chartered accountant is held guilty of professional misconduct if he certifies or submits a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or employee in his firm or any other chartered accountant in practice.

Mr. Mohan has issued a' certificate of consumption which does not reflect the correct factual position of the consumption of raw material by the concerned entity. He has failed in his duty of examining the record. He has relied on the minutes of Board of director's meeting which is not proper evidence to show the consumption of raw material. The relevant record of production and stock register should have been scrutinized thoroughly and properly.

Clause 7 of Part I of Second Schedule to the Chartered Accountants Act, 1949 also applies to this case which states that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

Mr. Mohan will be held guilty of Professional Misconduct under Clause 2 of Part 1 of Second Schedule to the Chartered Accountants Act, 1949.

Question 26

XYZ Ltd. appoints you as the auditor of the company. You observe that previous auditors A & Co., resigned. Also Balance Sheet as at 31-03-2014 shows an audit fee payable of ₹ 25,000. What precautions you will take before commencing the audit work?

Answer

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:

(i) Check whether a statement, in the prescribed form, has been filed by the resigning auditor within a period of 30 days from the date of resignation, to the company and the registrar (or the Comptroller and Auditor-General of India, as the case may be), indicating the reasons and other facts as may be relevant with regard to the resignation, for the compliance of Section 140(2) of the Companies Act, 2013 (herein after referred as the Act).

(ii) Ascertain that the appointment of new Auditor is in compliance with Section 139(8) of the Act as mentioned above i.e. the resolution appointing the new auditor has been approved by the company in the general meeting as in the case of casual vacancy by resignation.

(iii) The auditor must obtain the NOC from previous auditor. He should also refer the resignation statement file by the previous auditor and communicate with him (previous auditor) to ascertain the circumstances which led up him to retire.

(iv) The auditor must ascertain whether there existed any circumstances on account of which he should not accept the appointment.

(v) As per Section 139 of the Act, the auditor must ensure that before any appointment or reappointment of auditors is made at an annual general meeting, a written certificate has been provided by him to the company that his appointment is in accordance with the limits specified in Section 141(3)(g).

(vi) He should also satisfy himself that the notice provided for under Sections 139 and 140 has been effectively served on the outgoing auditor.

Further, Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts a position as auditor previously held by another chartered accountant without first communicating with him in writing. Moreover, Clause (9) of Part I of the same Schedule, 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 (now Section 139 and 140 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

Question 27

Give your comments with reference to the Chartered Accountants Act, 1949 and schedules thereto:

(a) CA Smart, a practicing Chartered Accountant was on Europe tour between 15-9-14 and 25-9-14. On 18-9-14 a message was received from one of his clients requesting for a stock certificate to be produced to the bank on or before 20-9-14. Due to urgency, CA Smart directed his assistant, who is also a Chartered Accountant, to sign and issue the stock certificate after due verification, on his behalf.

(b) A letter is sent by a Chartered Accountant in practice to the Ministry of Finance inquiring whether a panel of auditors is being maintained by the Ministry and if so to include his name in the panel (CV enclosed).

Answer

(a) As per clause 12 of Part I of the First Schedule of the Chartered Accountants Act, 1949, 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".

In this case CA Smart allowed his assistant who is not a partner but a member of the Institute of Chartered Accountants of India to sign stock certificate on his behalf and thereby commits misconduct.

Thus, CA Smart is guilty of professional misconduct under clause 12 of Part I of First Schedule of the Chartered Accountants Act, 1949.

(b) Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means. Such a restraint has been put so that the members maintain their independence of judgement and may be able to command respect from their prospective clients.

In case of making an application for the empanelment for the allotment of audit and other professional work, the Council has opined that, "where the existence of such a panel is within the knowledge of the member, he is free to write to the concerned organization with a request to place his name on the panel. However, it would not be proper for the member to make roving inquiries by applying to any such organization for having his name included in any such panel."

Accordingly, the member is guilty of misconduct in terms of the above provision as he has solicited professional work from the Finance Ministry, by inquiring about the maintenance of the panel.

Question 28

Comment on the following:

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

(b) Mr. J, a Chartered Accountant has identified that ABC Ltd. has taken a loan of ` 15 lakhs from Provident Fund Account, during the course of audit. The said loan was not reflected in the books of accounts and statements were prepared ignoring the same.

(c) Mr. K, a Chartered Accountant certified the circulation of a weekly magazine without examining the records and relevant documents.

(d) Mr. R, a Chartered Accountant in practice approached Manager of a Nationalised Bank for a loan of ` 25 lakhs. He has also informed the Manager that if the loan is sanctioned, the Income Tax return of the Manager and staff will be filed without charging any fees, as quid Pro quo for the loan sanctioned.

Answer

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

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

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

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

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

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

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

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

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

Thus, in the present case, Mr. K will be held guilty of professional misconduct under Clause (8) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

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

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

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

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

Question 29

Give your comments with reference to the Chartered Accountants Act, 1949 and Schedules thereto.

(a) Z, a practicing Chartered Accountant issued a certificate of circulation of a periodical without going into the most elementary details of how the circulation of a periodical was being maintained i.e. by not looking into the financial records, bank statements or bank pass books, by not examining evidence of actual payment of printers bills and by not caring to ascertain how many copies were sold and paid for.

(b) X, a practicing Chartered Accountant in an application for permission to study submitted by his Articled Assistant to the council had confirmed that the normal working hours of his office were from 11 A.M. to 6 P.M. and the hours during which the Articled Assistant was required to attend classes were 7.00 A.M. to 9.30 A.M. According to the information from College, the Articled Assistant attended the College from 10 A.M. to 1.55 P.M. on all week days. About the Articled Assistant attending the classes even during office hours, X pleaded ignorance.

(c) K, a practicing Chartered Accountant gave 50% of the audit fees received by him to L, who was not a Chartered Accountant, under the nomenclature of office allowance and such an arrangement continued for a number of years.

(d) M, a practicing Chartered Accountant sent a letter to another firm of Chartered Accountants, claiming himself to be a pioneer in liasoning with Central Government Ministries and its allied Departments for getting various Government clearances for which he had claimed to have expertise and had given a list of his existing clients and details of his staff etc.

Answer

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

In the instant case Mr. Z, a practicing Chartered Accountant issued a certificate of circulation of a periodical without going into the most elementary details of how the circulation of a periodical was being maintained i.e, by not looking into the financial records, bank statements or bank pass books, by not examining evidence of actual payment of printers bills and by not caring to ascertain how many copies were sold and paid for.

The chartered accountant should not express his opinion before obtaining the required data and information. As an auditor, Mr. Z ought to have verified the basic records to ensure the correctness of circulation figures.

Thus, in the present case Mr. Z will be held guilty of professional misconduct as per clause 8 of part I of Second Schedule of Chartered Accountants Act, 1949.

Alternative Solution is possible on the basis of clause 7 of Part-I of Second Schedule of The Chartered Accountants Act, 1949.

(b) Failure to Observe the Regulations: As per Clause 1 of Part II of Second Schedule to the Chartered Accountants Act, 1949 a member shall be held guilty of professional misconduct if he contravenes any of the provisions of the Act or the regulations made thereunder or any guidelines issued by the Council.

The chartered accountant, as per Regulations also, is expected to impart proper practical training. There is a specific circular issued which guides on timing for training for articleship.

In the instant case, the articled clerk must have not been attending office on a regular basis and the explanation of the Chartered Accountant cannot be accepted. It is also quite likely that the articled clerk would be availing leave quite often and coming late to the office.

Under the circumstances, the Chartered Accountant is guilty of misconduct for making a misstatement to the institute in regard to the discharge of his professional duties.

Note: Alternative Solution is possible as per Schedule II, Part II, Clause (3), a member is deemed to be 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, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false. In the instant case, X knew about the college timing of his articled assistant and he had given false information to the institute knowing them to be false and hence he will be deemed to be guilty of professional misconduct.

(c) Sharing of Audit Fees with non-member: As per Clause 2 of Part I of First Schedule to the Chartered Accountants Act, 1949 a member shall be held guilty if a Chartered Accountant in practice pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services to time in or outside India.

In the instant case, Mr. K, a practising Chartered Accountant gave 50% of the audit fees received by him to Mr. L, who was not a Chartered Accountant, under the nomenclature of office allowance and such an arrangement continued for a number of years. In this case, it is not the nomenclature to a transaction that is material but it is the substance of the transaction, which has to be looked into.

The Chartered Accountant had shared his profits and, therefore, Mr. K will be held guilty of professional misconduct under the Clause (2) of Part I of First Schedule to the Chartered Accountants Act, 1949.

(d) Soliciting work directly or indirectly: As per Clause 6 of Part I of First Schedule to the Chartered Accountants Act, 1949, a member shall be held guilty if a Chartered Accountant in practice solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

Further, as per Central Council Guidelines for Advertisement for the members in practice, write up of the members should not claim superiority over any other Member(s)/Firm(s) and should also not include the names of the clients.

In the present case, Mr. M, a practicing Chartered Accountant sent the letter to another firm of Chartered Accountants, claiming himself to be a pioneer in liasoning with Central Government Ministries and its allied Departments for getting various Government clearances for which he had claimed to have expertise and had also given a list of his existing clients and details of his staff etc. which seems to be indirect methods to adventure their professional practice with a view to gain publicity and thereby solicit clients or professional work.

Hence, Mr. M was guilty of professional misconduct as per Clause 6 of Part I of First Schedule of the Chartered Accountants Act, 1949.

Question 30

Give your comments with reference to the Companies Act and the Chartered Accountants Act, 1949 and Schedules thereto:

(a) A Chartered Accountant who was in practices since last 20 years died in a road accident. His widow sold the practice to another Chartered Accountant in practice for ₹ 30 lakhs. The price also included the right to use the firm name.

(b) K, Chartered Accountant in practice as a sole proprietor at Chennai has an office in the suburbs of Chennai. Due to increase in the income tax assessment work, he opens another office near the income tax office. For running the new office, he has employed a retired income Tax Commissioner.

(c) Mr. A has been appointed statutory auditor of a private limited company where his spouses' sisters' husband is having 75% ownership.

(d) Mr. E, proprietor of M/s. E & Co. is the statutory auditor of a Company which owns a store dealing in computer equipments. During the year 2013-14, E purchased a computer from the store costing ₹ 25,000 for his son. He did not make any payment for the same, but asked the company to adjust the same against the audit fees payable of ₹ 50,000.

Answer

(a) Sale of Goodwill: With reference to Clause (2) of Part I to the First Schedule to Chartered Accountants Act, 1949 the Council of the Institute of Chartered Accountants of India had an occasion to consider whether the goodwill of a proprietary concern of chartered accountant can be sold to another member who is otherwise eligible, after the death of the proprietor.

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 30.08.1998, 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 up to a period of one year from the death of the proprietor.

Thus, in the instant case, when the widow of the chartered accountant sold 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. Therefore, the above act of the widow of the Chartered Accountant is permissible.

(b) Maintenance of Branch Office in the same city: As per section 27 of the Chartered Accountants Act, 1949 if a chartered accountant in practice has more than one office in India, each one of these offices should be in the separate charge of a member of the Institute. However, a member can be in charge of two offices if the second office is located in the same premises or in the same city, in which the first office is located; or the second office is located within a distance of 50 Kilometres from the municipal limits of a city, in which the first office is located.

In the given case, Mr. K, Chartered Accountant in practice as a sole proprietor at Chennai has an office in suburbs of Chennai, and due to increase in the work he opened another branch near the income tax office. He also employed the income tax commissioner to run the new office.

Assuming that the second office is situated within a distance of 50 Kms from municipal limits, there will be no misconduct if Mr. K will be in charge of both the offices, however, he will be liable to declare which of the two offices is the main office.

Note: Alternative view is possible on the assumption that distance of both the office is more than 50 Km, Hence, Mr. K will be liable for misconduct under section 27 of the Chartered Accountant Act, 1949.

(c) Appointment of Auditor in case of substantial interest: Clause (4) of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that if an auditor expresses his opinion on the financial statements of any business or enterprises in which he, his firm or a partner in his firm or his relative has substantial interest, he is committing professional misconduct unless he discloses the interest in his report. Such disclosure is intended to assure the public as regard the faith and confidence that could be reposed in the independent opinion expressed by the auditor.

Further as per Council General Guidelines, 2008 the term relative shall have the same meaning as defined in AS 18 and spouses' sister' husband does not fall within this definition.

In the given case Mr. A, has been appointed as statutory auditor of a private limited company where his spouses' sisters' husband is having 75 % ownership i. e. substantial interest. As per AS 18, spouses' sisters' husband is not covered in the definition of the term relative.

Therefore, appointment of Mr. A as statutory auditor in such company would not amount to professional misconduct as per clause (4) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

(d) ***Independence of Auditor: 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 ₹ 1,000, 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) of the Companies Act, 1956 will be attracted." Now this limit has been increased from ₹ 1,000 to ₹ 5,00,000 as per the provisions of the Section 141(3)(d)(ii) of the Companies Act, 2013.***

This provision will be applicable in the case of purchase of Computer for his son or for personal work by the auditor of a company on normal terms and conditions of the business of the company if the amount outstanding at the end of the year exceeded the prescribed limit which is ₹ 5,00,000.

In the instant case, Mr. E, Proprietor of M/s E & Co. is the statutory auditor of a company which owns a store dealing in computer equipments, purchased a computer from the store and adjusted the payment for the same against his audit fee.

Therefore, the contention of Mr. E that he does not incur disqualification is correct as he has purchased a computer of the value of ₹ 25,000 which is not exceeding the prescribed limit and asked the company to adjust the same against the audit fees payable of ₹ 50,000.

Accordingly, Mr. E is not disqualified to be appointed as auditor of the company as he is indebted to the company for an amount not exceeding ₹ 5,00,000. Thus, Mr. E will not be held liable for guilty of professional misconduct.

Question 31

Give your comments with reference to Chartered Accountants Act, 1949 and Schedules thereto

(a) Mr. A, a practicing Chartered Accountant, failed to return the books of account and other documents of a client despite many reminders from the client. The client had settled his entire fees dues also.

(b) Mr. B, a practicing Chartered Accountant as well as a qualified lawyer, was permitted by the bar council to practice as a lawyer also. He printed his visiting card where he mentioned his designation as Chartered Accountant and Advocate.

(c) Mr. D, a practicing Chartered Accountant, did not complete his work relating to the audit of the accounts of a company and had not submitted his audit report in due time to enable the company to comply with the statutory requirements.

Answer

(a) A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, 1949, if he is found guilty of any professional or "Other Misconduct". As per part IV of the First Schedule to the Chartered Accountants Act, a member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he-

(1) is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months;

(2) 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 his professional work.

A member may be found guilty of "Other Misconduct", as per clause 2, under the aforesaid provisions rendering, himself unfit to be member if he retains the books of account and documents of the client and fails to return these to the client on request without a reasonable cause.

In the given case, Mr. A failed to return the books of accounts and other documents of his client without any reasonable cause, therefore, he would be guilty of professional misconduct under the aforesaid provisions.

(b) Under clause (7) of Part I of First Schedule to the Chartered Accountants Act, 1949, a CA in practice is deemed to be guilty of professional misconduct if he (i) advertises his professional attainments or services or (ii) uses any designation or expressions other than 'Chartered Accountant" on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a university established by law in India or recognized by the Central Government or a title indicating membership of the ICAI or of any other institution that has been recognized by the Central Government or may be recognized by the council.

This clause prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public.

Members of the Institute in practice who are otherwise eligible may practice as advocates subject to the permission of the Bar Council but in such case, they should not use designation 'chartered accountant in respect of the matters involving the practice as an advocate. In respect of other matters they should use the designation 'chartered accountant' but they should not use the designation 'chartered accountant' and 'advocate' simultaneously. Since Mr. B has printed his visiting card where he mentioned his designation as Chartered Accountant and Advocate which is prohibited under the above clause and hence Mr. B is guilty of professional misconduct.

(c) According to Clause (7) of Part I of Second Schedule of Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

It is a vital clause which unusually gets attracted whenever it is necessary to judge whether the accountant has honestly and reasonably discharged his duties. The expression negligence covers a wide field and extends from the frontiers of fraud to collateral minor negligence.

Where a Chartered Accountant had not completed his work relating to the audit of the accounts a company and had not submitted his audit report in due time to enable the company to comply with the statutory requirement in this regard. He was guilty of professional misconduct under Clause (7).

Since Mr. D has not completed his audit work in time and consequently could not submit audit report in due time and consequently, company could not comply with the statutory requirements, therefore, the auditor is guilty of professional misconduct under Clause (7) of Part I of the Second Schedule of the Chartered Accountants Act, 1949.

Question 32

(a) Mr. X who passed his CA examination of ICAI on 18th July, 2014 and started his practice from August 15, 2014. On 16th August 2014, one female candidate approached him for articleship. In addition to monthly stipend, Mr. X also offered her 1 % profits of his CA firm. She agreed to take both 1 % profits of the CA firm and stipend as per the rate prescribed by the ICAI. The Institute of Chartered Accountants of India sent a letter to Mr. X objecting the payment of 1 % profits. Mr. X replies to the ICAI stating that he is paying 1 % profits of his firm over and above the stipend to help the articled clerk as the financial position of the articled clerk is very weak. Is Mr. X Liable to professional misconduct?

(b) Mr. Honest, a Chartered Accountant in practice, wrote two letters to M/s XY Chartered Accountants a firm of CAs; requesting them to allot him some professional work. As he did not have a significant practice or clients he also wrote a letter to M/s ABC, a firm of Chartered Accountants for securing professional work. Mr. Clever, an another CA, informed ICAI regarding Mr. Honest's approach to secure the professional work. Is Mr. Honest wrong in soliciting professional work?

Answer

(a) As per Clause (2) of Part I of First Schedule of the Chartered Accountants Act 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services to time in or outside India.

In view of the above, the objections of the Institute of Chartered Accountants of India, as given in the case, are correct and reply of Mr. X, stating that he is paying 1 % profits of his firm over and above the stipend to help the articled clerk as the position of the articled clerk is weak is not tenable.

Hence, Mr. X is guilty of professional misconduct in terms of Clause (2) of Part I of First Schedule of the Chartered Accountants Act 1949.

(b) Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means. Provided that nothing herein contained shall be construed as preventing or prohibiting any Chartered Accountant from applying or requesting for or inviting or securing professional work from another chartered accountant in practice.

Such a restraint has been put so that the members maintain their independence of judgment and may be able to command respect from their prospective clients.

In the given case, Mr. Honest wrote letters only to other Chartered Accountants, M/s XY and M/s ABC requesting them to allot some professional work to him, which is not prohibited under Clause (6) as explained above. Thus, Mr. Honest is not wrong in soliciting professional work.

Question 33

C.A. Prabhu is a leading income tax practitioner and consultant for derivative products. He resides in Mumbai near to the ABC commodity stock exchange and does trading in commodity derivatives. Every day, he invests nearly 50% of his time to settle the commodity transactions. Is C.A. Prabhu liable for professional misconduct?

Answer

As per Clause (11) of Part I of First Schedule of Chartered Accountants Act, 1949, 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 so to engage.

However, the Council has granted general permission to the members to engage in certain specific occupation. In respect of all other occupations specific permission of the Institute is necessary.

In this case, CA Prabhu is engaged in the occupation of trading in commodity derivatives which is not covered under the general permission.

Hence specific permission of the Institute has to be obtained otherwise he will be deemed to be guilty of professional misconduct under Clause (11) of Part I of First Schedule of Chartered Accountants Act, 1949.

Question 34

Mr. Nigal, a Chartered Accountant in practice, delivered a speech in the national conference organized by the Ministry of Textiles. While delivering the speech, he told to the audience that he is a management expert and his firm provides services of taxation and audit at reasonable rates. He also requested the audience to approach his firm of chartered accountants for these services and at the request of audience he also

distributed his business cards and telephone number of his firm to those in the audience. Comment.

Answer

Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means. Such a restraint has been put so that the members maintain their independence of judgment and may be able to command respect from their prospective clients.

Section 7 of the Chartered Accountants Act, 1949 read with Clause 7 of Part I of the First Schedule to the said Act prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a chartered accountant in documents through which the professional attainments of the member would come to the notice of the public. Under the clause, use of any designation or expression other than chartered accountant for a chartered accountant in practice, on professional documents, visiting cards, etc. amounts to a misconduct unless it be a degree of a university or a title indicating membership of any other professional body recognised by the Central Government or the Council.

Member may appear on television and films and agree to broadcast in the Radio or give lectures at forums and may give their names and describe themselves as Chartered Accountants. Special qualifications or specialized knowledge directly relevant to the subject matter of the programme may also be given but no reference should be made, in the case of practicing member to the name and address or services of his firm. What he may say or write must not be promotional of his or his firm but must be an objective professional view of the topic under consideration.

Thus, it is improper to use designation "Management Expert" since neither it is a degree of a University established by law in India or recognised by the Central Government nor it is a recognised professional membership by the Central Government or the Council. Therefore, he is deemed to be guilty of professional misconduct under both clause (6) and Clause (7) as he has used the designation "Management Expert" in his speech and also he has made reference to the services provided by his firm of Chartered Accountants at reasonable rates. Distribution of cards to audience is also a misconduct in terms of Clause 6.

Question 35

Give your comments with reference to Chartered Accountants Act, 1949 and Schedules there to.

(a) Mr. 'E', a practicing Chartered Accountant, was requested by one of his client to prepare a projection for next five years and also a report on the same. Mr. 'E' after having prepared the same stated in his report 'The sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts. He also stated that he does not vouch for the accuracy of the forecasts.

(b) Mr. 'A' is a practicing Chartered Accountant working as proprietor of M/s A & Co. He went abroad for 3 months. He delegated the authority to Mr. 'Y' a Chartered Accountant his employee for taking care of routine matters of his office. During his absence Mr. 'Y' has conducted the under mentioned jobs in the name of M/s A & Co.

(i) He issued the audit queries to client which were raised during the course of audit.

(ii) He issued production certificate to a client under Central Excise Act, 1944.

(iii) He attended the Income Tax proceedings for a client as authorized representative before Income Tax Authorities.

Please comment on eligibility of Mr. 'Y' for conducting such jobs in name of M/s A & Co. and liability of Mr. 'A' under the Chartered Accountants Act, 1949.

(c) Mr. 'G', while applying for a certificate of practice, did not fill in the columns which solicite information about his engagement in other occupation or business, while he was indeed engaged in a business.

(d) Mr. 'C', a Chartered Accountant holds a certificate of practice while in employment also, recommends a particular lawyer to his employer in respect of a case. The lawyer, out of the professional fee received from employer paid a particular sum as referral fee to Mr. 'C'.

Answer

(a) Certification of Financial Forecast: As per Clause (3) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice is deemed to be guilty of professional misconduct if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast.

Accuracy does not refer to arithmetical accuracy. All forecasts are estimates based on certain assumptions duly evaluated on a consideration of various relevant factors and cannot be ascertained with accuracy. The Guidance Note on Accountants Report on Profit Forecasts and/or Financial forecast considered the implications of this clause and made it clear that the chartered accountant can participate in the preparation of profit or financial forecasts and review them. But, first of all, he should clearly indicate in his report the sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts and, secondly, he should not vouch for the accuracy of the forecasts.

In the instant case, Mr. E after having prepared the projections for next five years stated in his report, "the sources of information, the basis of forecasts and also

the major assumptions made in arriving at the forecasts." He also stated that he does not vouch for the accuracy of the forecasts. Therefore there is no violation of the Chartered Accountants Act, 1949 and its Regulations.

(b) Delegation of Authority to the Employee: As per clause 12 of Part I of the First Schedule of the Chartered Accountants Act, 1949, 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".

In this case CA 'A' proprietor of M/s A & Co., went to abroad and delegated the authority to another Chartered Accountant Mr. Y, his employee, for taking care of routine matters of his office who is not a partner but a member of the Institute of Chartered Accountants

The Council has clarified that the power to sign routine documents on which a professional opinion or authentication is not required to be expressed may be delegated in the following instances and such delegation will not attract provisions of this clause like issue of audit queries during the course of audit, asking for information or issue of questionnaire, attending to routing matters in tax practice, subject to provisions of Section 288 of Income Tax Act etc.

(i) In the given case, Mr. 'Y', a chartered accountant being employee of M/s A & Co has issued audit queries which were raised during the course of audit. Here "Y" is right in issuing the query, since the same falls under routine work which can be delegated by the auditor. Therefore, there is no misconduct in this case as per clause 12 of Part 1 of First schedule to the Act.

(ii) Further, issuance of production certificate to a client under Central Excise Act, 1944 by Mr. "Y" being an employee of M/s A & Co. (an audit firm), is not a routine work and it is outside his authorities. Thus, CA 'A' is guilty of professional misconduct under clause 12 of Part I of First Schedule of the Chartered Accountants Act, 1949.

(iii) In this instance, Mr. "Y", CA employee of the audit firm M/s A & Co. has attended the Income tax proceedings for a client as authorized representative before Income Tax Authorities. Since the council has allowed the delegation of such work, the chartered accountant employee can attend to routine matter in tax practice as decided by the council, subject to provisions of Section 288 of the Income Tax Act. Therefore, there is no misconduct in this case as per clause 12 of Part 1 of First schedule to the Act.

(c) Disclosure of Information: As per Clause 2 of Part III of First Schedule to the Chartered Accountants Act, 1949 a member shall be held guilty if a Chartered Accountant, in practice or not, does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority;

In the given case, Mr. "G", a Chartered Accountant while applying for a certificate of practice, did not fill in the columns which solicit information about his engagement in other occupation or business, while he was indeed engaged in a business. Details of engagement in business need to be disclosed while applying for the certificate of practice as it was the information called for in the application, by the Institute.

Thus, Mr. G will be held guilty for professional misconduct under the clause 2 of Part III of First Schedule of the Chartered Accountants Act, 1949.

(d) Referral Fee from Lawyer: According to Clause 2 of Part II of First Schedule of the Chartered Accountant Act, 1949, a member of the Institute(other than a member in practice) shall be guilty of professional misconduct, if he being an employee of any company, firm or person accepts or agrees to accept any part of fee, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

In the present case, Mr. C who beside holding a certificate of practice, is also an employee and by referring a lawyer to the company in respect of a case, he receives a particular sum as referral fee from the lawyer out of his professional fee.

Therefore, Mr. C is guilty of professional misconduct by virtue of clause 2 of Part II of First schedule.

22

Professional Ethics

Question 1

(a) Mr. X who passed his CA examination of ICAI on 18th July, 2013 and started his practice from August 15, 2013. On 16th August 2013, one female candidate approached him for articleship. In addition to monthly stipend, Mr. X also offered her 1 % profits of his CA firm. She agreed to take both 1 % profits of the CA firm and stipend as per the rate prescribed by the ICAI. The Institute of Chartered Accountants of India sent a letter to Mr. X objecting the payment of 1 % profits. Mr. X replies to the ICAI stating that he is paying 1 % profits of his firm over and above the stipend to help the articled clerk as the financial position of the articled clerk is very weak. Is Mr. X Liable to professional misconduct?

(b) Mr. Honest, a Chartered Accountant in practice, wrote two letters to M/s XY Chartered Accountants a firm of CAs; requesting them to allot him some professional work. As he did not have a significant practice or clients he also wrote a letter to M/s ABC, a firm of Chartered Accountants for securing professional work. Mr. Clever, an another CA, informed ICAI regarding Mr. Honest's approach to secure the professional work. Is Mr. Honest wrong in soliciting professional work? (4 Marks each, November, 2013)

Answer

(a) As per Clause (2) of Part I of First Schedule of the Chartered Accountants Act 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services to time in or outside India.

In view of the above, the objections of the Institute of Chartered Accountants of India, as given in the case, are correct and reply of Mr. X, stating that he is paying 1 % profits of his firm over and above the stipend to help the articled clerk as the position of the articled clerk is weak is not tenable.

Hence, Mr. X is guilty of professional misconduct in terms of Clause (2) of Part I of First Schedule of the Chartered Accountants Act 1949.

(b) Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means. Provided that nothing herein contained shall be construed as preventing or prohibiting any Chartered Accountant from applying or requesting for or inviting or securing professional work from another chartered accountant in practice.

Such a restraint has been put so that the members maintain their independence of judgment and may be able to command respect from their prospective clients.

In the given case, Mr. Honest wrote letters only to other Chartered Accountants, M/s XY and M/s ABC requesting them to allot some professional work to him, which is not prohibited under Clause (6) as explained above. Thus, Mr. Honest is not wrong in soliciting professional work.

Question 2

C.A. Prabhu is a leading income tax practitioner and consultant for derivative products. He resides in Mumbai near to the ABC commodity stock exchange and does trading in commodity derivatives. Every day, he invests nearly 50% of his time to settle the commodity transactions. Is C.A. Prabhu liable for professional misconduct? (4 Marks, November, 2013)

Answer

As per Clause (11) of Part I of First Schedule of Chartered Accountants Act, 1949, 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 so to engage.

However, the Council has granted general permission to the members to engage in certain specific occupation. In respect of all other occupations specific permission of the Institute is necessary.

In this case, CA Prabhu is engaged in the occupation of trading in commodity derivatives which is not covered under the general permission.

Hence specific permission of the Institute has to be obtained otherwise he will be deemed to be guilty of professional misconduct under Clause (11) of Part I of First Schedule of Chartered Accountants Act, 1949.

Question 3

Mr. Nigal, a Chartered Accountant in practice, delivered a speech in the national conference organized by the Ministry of Textiles. While delivering the speech, he told to the audience that he is a management expert and his firm provides services of taxation and audit at reasonable rates. He also requested the audience to approach his firm of chartered accountants for these services and at the request of audience he also distributed his business cards and telephone number of his firm to those in the audience. Comment. (4 Marks, November, 2013)

Answer

Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means. Such a restraint has been put so that the members maintain their independence of judgment and may be able to command respect from their prospective clients.

Section 7 of the Chartered Accountants Act, 1949 read with Clause 7 of Part I of the First Schedule to the said Act prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a chartered accountant in documents through which the professional attainments of the member would come to the notice of the public. Under the clause, use of any designation or expression other than chartered accountant for a chartered accountant in practice, on professional documents, visiting cards, etc. amounts to a misconduct unless it be a degree of a university or a title indicating membership of any other professional body recognised by the Central Government or the Council.

Member may appear on television and films and agree to broadcast in the Radio or give lectures at forums and may give their names and describe themselves as Chartered Accountants. Special qualifications or specialized knowledge directly relevant to the subject matter of the programme may also be given but no reference should be made, in the case of practicing member to the name and address or services of his firm. What he may say or write must not be promotional of his or his firm but must be an objective professional view of the topic under consideration.

Thus, it is improper to use designation "Management Expert" since neither it is a degree of a University established by law in India or recognised by the Central Government nor it is a recognised professional membership by the Central Government or the Council. Therefore, he is deemed to be guilty of professional misconduct under both clause (6) and Clause (7) as he has used the designation “Management Expert” in his speech and also he has made reference to the services provided by his firm of Chartered Accountants at reasonable rates. Distribution of cards to audience is also a misconduct in terms of Clause 6.

Question 4

Give your comments with reference to Chartered Accountants Act, 1949 and Schedules thereto

(a) Mr. A, a practicing Chartered Accountant, failed to return the books of account and other documents of a client despite many reminders from the client. The client had settled his entire fees dues also.

(b) Mr. B, a practicing Chartered Accountant as well as a qualified lawyer, was permitted by the bar council to practice as a lawyer also. He printed his visiting card where he mentioned his designation as Chartered Accountant and Advocate.

(c) Mr. C, a practicing Chartered Accountant, in the course of the audit of a listed company discovered serious violations of the provisions of the Companies Act 1956, informed the Registrar of Companies out of public interest.

(d) Mr. D, a practicing Chartered Accountant, did not complete his work relating to the audit of the accounts of a company and had not submitted his audit report in due time to enable the company to comply with the statutory requirements. (4 Marks each, May, 2013)

Answer

(a) A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, 1949, if he is found guilty of any professional or “Other Misconduct”. As per part IV of the First Schedule to the Chartered Accountants Act, a member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he-

(1) is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months;

(2) 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 his professional work.

A member may be found guilty of “Other Misconduct”, as per clause 2, under the aforesaid provisions rendering, himself unfit to be member if he retains the books of account and documents of the client and fails to return these to the client on request without a reasonable cause.

In the given case, Mr. A failed to return the books of accounts and other documents of his client without any reasonable cause, therefore, he would be guilty of professional misconduct under the aforesaid provisions.

(b) Under clause (7) of Part I of First Schedule to the Chartered Accountants Act, 1949, a CA in practice is deemed to be guilty of professional misconduct if he (i) advertises his professional attainments or services or (ii) uses any designation or expressions other than ‘Chartered Accountant” on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a university established by law in India or recognized by the Central Government or a title indicating membership of the ICAI or of any other institution that has been recognized by the Central Government or may be recognized by the council.

This clause prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public.

Members of the Institute in practice who are otherwise eligible may practice as advocates subject to the permission of the Bar Council but in such case, they should not use designation ‘chartered accountant in respect of the matters involving the practice as an advocate. In respect of other matters they should use the designation ‘chartered accountant’ but they should not use the designation ‘chartered accountant’ and ‘advocate’ simultaneously. Since Mr. B has printed his visiting card where he mentioned

his designation as Chartered Accountant and Advocate which is prohibited under the above clause and hence Mr. B is guilty of professional misconduct.

(c) This question is redundant in view of the provisions of the Companies Act, 2013.

(d) According to Clause (7) of Part I of Second Schedule of Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

It is a vital clause which unusually gets attracted whenever it is necessary to judge whether the accountant has honestly and reasonably discharged his duties. The expression negligence covers a wide field and extends from the frontiers of fraud to collateral minor negligence.

Where a Chartered Accountant had not completed his work relating to the audit of the accounts a company and had not submitted his audit report in due time to enable the company to comply with the statutory requirement in this regard. He was guilty of professional misconduct under Clause (7).

Since Mr. D has not completed his audit work in time and consequently could not submit audit report in due time and consequently, company could not comply with the statutory requirements, therefore, the auditor is guilty of professional misconduct under Clause (7) of Part I of the Second Schedule of the Chartered Accountants Act, 1949.

Question 5

Give your comments with reference to the Companies Act, 1956 and the Chartered Accountants Act, 1949 and Schedules thereto:

(a) A Chartered Accountant who was in practices since last 20 years died in a road accident. His widow sold the practice to another Chartered Accountant in practice for ₹ 30 lakhs. The price also included the right to use the firm name.

(b) K, Chartered Accountant in practice as a sole proprietor at Chennai has an office in the suburbs of Chennai. Due to increase in the income tax assessment work, he opens another office near the income tax office. For running the new office, he has employed a retired income Tax Commissioner.

(c) Mr. A has been appointed statutory auditor of a private limited company where his spouses' sisters' husband is having 75% ownership.

(d) Mr. E, proprietor of M/s. E & Co. is the statutory auditor of a Company which owns a store dealing in computer equipments. During the year 2011-12, E purchased a computer from the store costing ₹ 25,000 for his son. He did not make any payment for the same, but asked the company to adjust the same against the audit fees payable of ₹ 50,000.

(4 Marks each, November, 2012)

Answer

(a) Sale of Goodwill: With reference to Clause (2) of Part I to the First Schedule to Chartered Accountants Act, 1949 the Council of the Institute of Chartered Accountants of India had an occasion to consider whether the goodwill of a proprietary concern of chartered accountant can be sold to another member who is otherwise eligible, after the death of the proprietor.

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 30.08.1998, 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 up to a period of one year from the death of the proprietor.

Thus, in the instant case, when the widow of the chartered accountant sold 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. Therefore, the above act of the widow of the Chartered Accountant is permissible.

(b) Maintenance of Branch Office in the same city: As per section 27 of the Chartered Accountants Act, 1949 if a chartered accountant in practice has more than one office in India, each one of these offices should be in the separate charge of a member of the Institute. However, a member can be in charge of two offices if the second office is located in the same premises or in the same city, in which the first office is located; or the second office is located within a distance of 50 Kilometres from the municipal limits of a city, in which the first office is located.

In the given case, Mr. K, Chartered Accountant in practice as a sole proprietor at Chennai has an office in suburbs of Chennai, and due to increase in the work he opened another branch near the income tax office. He also employed the income tax commissioner to run the new office.

Assuming that the second office is situated within a distance of 50 Kms from municipal limits, there will be no misconduct if Mr. K will be in charge of both the offices, however, he will be liable to declare which of the two offices is the main office.

Note: Alternative view is possible on the assumption that distance of both the office is more than 50 Km, Hence, Mr. K will be liable for misconduct under section 27 of the Chartered Accountant Act, 1949.

(c) Appointment of Auditor in case of substantial interest: Clause (4) of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that if an auditor expresses his opinion on the financial statements of any business or enterprises in which he, his firm or a partner in his firm or his relative has substantial interest, he is committing professional misconduct unless he discloses the interest in his report. Such disclosure is intended to

assure the public as regard the faith and confidence that could be reposed in the independent opinion expressed by the auditor.

Further as per Council General Guidelines, 2008 the term relative shall have the same meaning as defined in AS 18 and spouses' sister' husband does not fall within this definition.

In the given case Mr. A, has been appointed as statutory auditor of a private limited company where his spouses' sisters' husband is having 75 % ownership i. e. substantial interest. As per AS 18, spouses' sisters' husband is not covered in the definition of the term relative.

Therefore, appointment of Mr. A as statutory auditor in such company would not amount to professional misconduct as per clause (4) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

(d) Independence of Auditor: 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 ₹ 1,000, 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) of the Companies Act, 1956 will be attracted." Now this limit has been increased from ₹ 1,000 to ₹ 5,00,000 as per the provisions of the Section 141(3)(d)(ii) of the Companies Act, 2013.

This provision will be applicable in the case of purchase of Computer for his son or for personal work by the auditor of a company on normal terms and conditions of the business of the company if the amount outstanding at the end of the year exceeded the prescribed limit which is ₹ 5,00,000.

In the instant case, Mr. E, Proprietor of M/s E & Co. is the statutory auditor of a company which owns a store dealing in computer equipments, purchased a computer from the store and adjusted the payment for the same against his audit fee.

Therefore, the contention of Mr. E that he does not incur disqualification is correct as he has purchased a computer of the value of ₹ 25,000 which is not exceeding the prescribed limit and asked the company to adjust the same against the audit fees payable of ₹ 50,000.

Accordingly, Mr. E is not disqualified to be appointed as auditor of the company as he is indebted to the company for an amount not exceeding ₹ 5,00,000. Thus, Mr. E will not be held liable for guilty of professional misconduct.

Question 6

Give your comments with reference to the Chartered Accountants Act, 1949 and Schedules thereto.

(a) Z, a practicing Chartered Accountant issued a certificate of circulation of a periodical without going into the most elementary details of how the circulation of a periodical was being maintained i.e. by not looking into the financial records, bank statements or bank pass books, by not examining evidence of actual payment of printers bills and by not caring to ascertain how many copies were sold and paid for.

(b) X, a practicing Chartered Accountant in an application for permission to study submitted by his Articled Assistant to the council had confirmed that the normal working hours of his office were from 11 A.M. to 6 P.M. and the hours during which the Articled Assistant was required to attend classes were 7.00 A.M. to 9.30 A.M. According to the information from College, the Articled Assistant attended the College from 10 A.M. to 1.55 P.M. on all week days. About the Articled Assistant attending the classes even during office hours, X pleaded ignorance.

(c) K, a practicing Chartered Accountant gave 50% of the audit fees received by him to L, who was not a Chartered Accountant, under the nomenclature of office allowance and such an arrangement continued for a number of years.

(d) M, a practicing Chartered Accountant sent a letter to another firm of Chartered Accountants, claiming himself to be a pioneer in liasoning with Central Government Ministries and its allied Departments for getting various Government clearances for which he had claimed to have expertise and had given a list of his existing clients and details of his staff etc. *(4 Marks each, May, 2012)*

Answer

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

In the instant case Mr. Z, a practicing Chartered Accountant issued a certificate of circulation of a periodical without going into the most elementary details of how the circulation of a periodical was being maintained i.e, by not looking into the financial records, bank statements or bank pass books, by not examining evidence of actual payment of printers bills and by not caring to ascertain how many copies were sold and paid for.

The chartered accountant should not express his opinion before obtaining the required data and information. As an auditor, Mr. Z ought to have verified the basic records to ensure the correctness of circulation figures.

Thus, in the present case Mr. Z will be held guilty of professional misconduct as per clause 8 of part I of Second Schedule of Chartered Accountants Act, 1949.

Alternative Solution is possible on the basis of clause 7 of Part-I of Second Schedule of The Chartered Accountants Act, 1949.

(b) Failure to Observe the Regulations: As per Clause 1 of Part II of Second Schedule to the Chartered Accountants Act, 1949 a member shall be held guilty of professional misconduct if he contravenes any of the provisions of the Act or the regulations made thereunder or any guidelines issued by the Council.

The chartered accountant, as per Regulations also, is expected to impart proper practical training. There is a specific circular issued which guides on timing for training for articleship.

In the instant case, the articled clerk must have not been attending office on a regular basis and the explanation of the Chartered Accountant cannot be accepted. It is also quite likely that the articled clerk would be availing leave quite often and coming late to the office.

Under the circumstances, the Chartered Accountant is guilty of misconduct for making a misstatement to the institute in regard to the discharge of his professional duties.

Note: Alternative Solution is possible as per Schedule II, Part II, Clause (3), a member is deemed to be 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, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false. In the instant case, X knew about the college timing of his articled assistant and he had given false information to the institute knowing them to be false and hence he will be deemed to be guilty of professional misconduct.

(c) Sharing of Audit Fees with non-member: As per Clause 2 of Part I of First Schedule to the Chartered Accountants Act, 1949 a member shall be held guilty if a Chartered Accountant in practice pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services to time in or outside India.

In the instant case, Mr. K, a practising Chartered Accountant gave 50% of the audit fees received by him to Mr. L, who was not a Chartered Accountant, under the nomenclature of office allowance and such an arrangement continued for a number of years. In this case, it is not the nomenclature to a transaction that is material but it is the substance of the transaction, which has to be looked into.

The Chartered Accountant had shared his profits and, therefore, Mr. K will be held guilty of professional misconduct under the Clause (2) of Part I of First Schedule to the Chartered Accountants Act, 1949.

(d) Soliciting work directly or indirectly: As per Clause 6 of Part I of First Schedule to the Chartered Accountants Act, 1949, a member shall be held guilty if a Chartered Accountant in practice solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

Further, as per Central Council Guidelines for Advertisement for the members in practice, write up of the members should not claim superiority over any other Member(s)/Firm(s) and should also not include the names of the clients.

In the present case, Mr. M, a practicing Chartered Accountant sent the letter to another firm of Chartered Accountants, claiming himself to be a pioneer in liasoning with Central Government Ministries and its allied Departments for getting various Government clearances for which he had claimed to have expertise and had also given a list of his existing clients and details of his staff etc. which seems to be indirect methods to adventure their professional practice with a view to gain publicity and thereby solicit clients or professional work.

Hence, Mr. M was guilty of professional misconduct as per Clause 6 of Part I of First Schedule of the Chartered Accountants Act, 1949.

Question 7

Comment on the following:

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

(b) Mr. J, a Chartered Accountant has identified that ABC Ltd. has taken a loan of ₹ 15 lakhs from Provident Fund Account, during the course of audit. The said loan was not reflected in the books of accounts and statements were prepared ignoring the same.

(c) Mr. K, a Chartered Accountant certified the circulation of a weekly magazine without examining the records and relevant documents.

(d) Mr. R, a Chartered Accountant in practice approached Manager of a Nationalised Bank for a loan of ₹ 25 lakhs. He has also informed the Manager that if the loan is sanctioned, the Income Tax return of the Manager and staff will be filed without charging any fees, as quid Pro quo for the loan sanctioned. (4 Marks each, November, 2011)

Answer

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

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

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

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

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

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

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

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

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

Thus, in the present case, Mr. K will be held guilty of professional misconduct under Clause (8) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

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

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

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

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

Question 8

Give your comments with reference to the Chartered Accountants Act, 1949 and schedules thereto:

(a) CA Smart, a practicing Chartered Accountant was on Europe tour between 15-9-10 and 25-9-10. On 18-9-10 a message was received from one of his clients requesting for a stock certificate to be produced to the bank on or before 20-9-10. Due to urgency, CA Smart directed his assistant, who is also a Chartered Accountant, to sign and issue the stock certificate after due verification, on his behalf.

(b) Mr. Kishore, a practicing Chartered Accountant was appointed by the Central Government to carry out a special audit u/s 233A of the Companies Act, 1956. He accepted the appointment and proceeded with the work without communicating to the statutory auditor of the company.

(c) Mr. Sodhi, a Chartered Accountant in practice, who is proposed to be removed as the auditor of a company makes unsubstantiated and derogatory remarks against the management of the company in his representation u/s 225 of the Companies Act, 1956.

(d) A letter is sent by a Chartered Accountant in practice to the Ministry of Finance inquiring whether a panel of auditors is being maintained by the Ministry and if so to include his name in the panel (CV enclosed). (4 Marks each, May, 2011)

Answer

(a) As per clause 12 of Part I of the First Schedule of the Chartered Accountants Act, 1949, 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".

In this case CA Smart allowed his assistant who is not a partner but a member of the Institute of Chartered Accountants of India to sign stock certificate on his behalf and thereby commits misconduct.

Thus, CA Smart is guilty of professional misconduct under clause 12 of Part I of First Schedule of the Chartered Accountants Act, 1949.

(b) This question is redundant in view of the provisions of the Companies Act, 2013.

(c) This question is redundant in view of the provisions of the Companies Act, 2013.

(d) Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means. Such a restraint has been put so that the members maintain their independence of judgement and may be able to command respect from their prospective clients.

In case of making an application for the empanelment for the allotment of audit and other professional work, the Council has opined that, "where the existence of such a panel is

within the knowledge of the member, he is free to write to the concerned organization with a request to place his name on the panel. However, it would not be proper for the member to make roving inquiries by applying to any such organization for having his name included in any such panel."

Accordingly, the member is guilty of misconduct in terms of the above provision as he has solicited professional work from the Finance Ministry, by inquiring about the maintenance of the panel.

Question 9

Give your comments with reference to the Chartered Accountants Act, 1949 and schedules thereto:

(a) PQR and Associates, Chartered Accountants have their website and on the letterhead of the firm it is mentioned that "Visit our website: PQR com". In the website the nature of assignments handled, names of prominent clients and fees charged is also displayed.

(b) Mr. B is a practising Chartered Accountant holding a valid certificate of practice. He accepted the appointment as Director of the Green World Co. Ltd. Mr. C, a partner of Mr. B is statutory auditor of the said company.

(c) YKS & Co., a proprietary firm of Chartered Accountants was appointed as concurrent auditor of a bank. YKS used his influence for getting some cheques purchased and thereafter failed to repay the loan/overdraft.

(d) Mr. Mohan is a practising Chartered Accountant. He issued a certificate of consumption which did not reflect the correct factual position of the consumption of raw material by the concerned entity. It is found that the certificate is given on the basis of data appearing in the minutes of meeting of the Board of Directors. (4 Marks each, November, 2010)

Answer

(a) The Council of the Institute of Chartered Accountants has issued guidelines for posting the particulars on Website by Chartered Accountants in practice and firms of Chartered Accountants in practice under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949. According to the guidelines the details in the website should be so designed that it does not amount to soliciting client or professional work. It is permitted to mention the website address on letterhead but soliciting people to visit website is not permitted. PQR and Associates letterhead invites to people to visit their website. Similarly the website mentions the nature of assignments, names of the prominent clients and fees charged. The nature of assignments is permitted for display only on specific 'Pull" request. And the name of clients, the fees charged is not permitted at all.

PQR & Associates will be held guilty of Professional Misconduct under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949.

(b) Clause 11 of Part 1 of First Schedule to the Chartered Accountants Act, 1949 prohibits a member to engage in any business or occupation other than the profession of chartered accountants unless permitted by the Council so to engage. It does not prohibit a Chartered Accountant from being a director of a company, except managing director or a whole time director. But if any of the partners is interested in such company as an auditor then he cannot be director of the said company. In the present case Mr. B has accepted the directorship in a Company where his partner Mr. C is an auditor without obtaining specific permission of the council. Hence, Mr. B will be held guilty for professional misconduct under Clause (11) of Part 1 of First Schedule to the Chartered Accountants Act, 1949.

Further, the Council of the Institute of Chartered Accountants of India has categorically stated that in cases where a member is a director of a company, the firm, in which the said member is a partner, should not express any opinion on its financial statements. Clause (4) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 states that expressing an opinion on financial statement of any business establishment in which the auditor, his firm or a partner of his firm has a substantial interest would constitute misconduct.

Additionally, Section 141(3)(c) of the Companies Act, 2013 also disqualifies a person to be appointed as an auditor if he is a partner of an officer of the company. Furthermore, section 141(4) of the Companies Act, 2013 requires the appointed auditor to vacate his office if he incurs any of the disqualifications mentioned under sub-section (3).

Therefore, in cases, where a member of the Institute is a director of a company or a firm in which said member is a partner should not express any opinion on its financial statements. Hence Mr. C, a partner of Mr. B, should vacate the office.

(c) This is a case which is covered under the expression in other misconduct of the Chartered Accountants Act, 1949. As per Clause (2) of Part IV of First Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be 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 his professional work. Here the Chartered Accountant is expected to maintain the highest standards and integrity even in his personal affairs and any deviation from these standards calls for disciplinary action.

In the present case, YKS & Co, being a concurrent auditor used his position to obtain the funds and failed to repay the same to the bank. This brings disrepute to the profession of a Chartered Accountant. This act of YKS & Co is not pardonable.

Therefore, YKS & Co will be held guilty of other misconduct under Clause (2) of Part IV of First Schedule to the Chartered Accountants Act, 1949.

(d) According to Clause 2 of Part 1 of Second Schedule to the Chartered Accountants Act, 1949 a chartered accountant is held guilty of professional misconduct if he certifies or submits a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or employee in his firm or any other chartered accountant in practice.

Mr. Mohan has issued a' certificate of consumption which does not reflect the correct factual position of the consumption of raw material by the concerned entity. He has failed in his duty of examining the record. He has relied on the minutes of Board of director's meeting which is not proper evidence to show the consumption of raw material. The

relevant record of production and stock register should have been scrutinized thoroughly and properly.

Clause 7 of Part I of Second Schedule to the Chartered Accountants Act, 1949 also applies to this case which states that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

Mr. Mohan will be held guilty of Professional Misconduct under Clause 2 of Part 1 of Second Schedule to the Chartered Accountants Act, 1949.

Question 10

XYZ Ltd. appoints you as the auditor of the company. You observe that previous auditors A & Co., resigned. Also Balance Sheet as at 31-03-2010 shows an audit fee payable of ₹ 25,000. What precautions you will take before commencing the audit work? (4 Marks, November, 2010)

Answer

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:

(i) Check whether a statement, in the prescribed form, has been filed by the resigning auditor within a period of 30 days from the date of resignation, to the company and the registrar (or the Comptroller and Auditor-General of India, as the case may be), indicating the reasons and other facts as may be relevant with regard to the resignation, for the compliance of Section 140(2) of the Companies Act, 2013 (herein after referred as the Act).

(ii) Ascertain that the appointment of new Auditor is in compliance with Section 139(8) of the Act as mentioned above i.e. the resolution appointing the new auditor has been approved by the company in the general meeting as in the case of casual vacancy by resignation.

(iii) The auditor must obtain the NOC from previous auditor. He should also refer the resignation statement file by the previous auditor and communicate with him (previous auditor) to ascertain the circumstances which led up him to retire.

(iv) The auditor must ascertain whether there existed any circumstances on account of which he should not accept the appointment.

(v) As per Section 139 of the Act, the auditor must ensure that before any appointment or reappointment of auditors is made at an annual general meeting, a written certificate has been provided by him to the company that his appointment is in accordance with the limits specified in Section 141(3)(g).

(vi) He should also satisfy himself that the notice provided for under Sections 139 and 140 has been effectively served on the outgoing auditor.

Further, Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts a position as auditor previously held by another chartered accountant without first communicating with him in writing. Moreover, Clause (9) of Part I of the same Schedule, 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 (now Section 139 and 140 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

Question 11

Give your comments with reference to the Chartered Accountants Act, and Schedules thereto:

(a) Mr. A, a practicing Chartered Accountant, took over as the executive chairman of Software Company on 1.4.2010. On 10.4.2010 he applied to the Council for permission.

(b) Mr. X, a practicing Chartered Accountant, issued a circulation certificate for a periodical on the basis of outward memos, which was later found to be false.

(c) Mr. Z, a practicing Chartered Accountant, received a sum of ₹ 1 lac on 1.9.2009 from a Client who intends to leave abroad for a period of a year, with a request that his advance tax liabilities to be paid over the three instalments. On 15th September, 2009, 15th December, 2009 and 15th March, 2010. After remitting the 1st instalment of advance tax on 15.9.2009, Z did not keep the Balance Money in a separate Bank account and he is of the opinion he will remit the money within reasonable time as per payment schedule of Advance tax.

(d) Mr. X, a Chartered Accountant, employed as a paid Assistant with a Chartered Accountant firm. On 31st December, 2008 he leaves the services of the firm. Despite many reminders from ICAI he fails to reply regarding the date of leaving the services of the firm. (4 Marks each, May, 2010)

Answer

(a) Specific Permission to be obtained: As per Clause (11) of Part I of First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice will be 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 so to engage.

In the instant case, Mr. A took over as the executive chairman on 01.04.2010 and applied for permission on 10.04.2010. On the basis of these facts, he was engaged in other occupation between the period 01.04.2010 and 10.04.2010, without the permission of the Council and therefore, Mr. A is guilty of professional misconduct in terms of Clause (11) of Part I of First Schedule of the Chartered Accountants Act, 1949.

(b) Failure to obtain information: As per Clause (8) of Part I of Second Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice, will be deemed to be guilty of professional misconduct if he fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion.

This indicates a Chartered Accountant must determine the extent of information, which, should be obtained by him before he expresses an opinion on the financial statements.

In the present case, Mr. X certifies the circulation based on outward memos, without going into the most elementary details of how the circulation of a periodical was maintained, i.e. not verifying the financial records, bank statements, collections for the periodicals, payment of the printer's bills etc. Hence, he is guilty of professional misconduct as per Clause (8) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

(c) Money of client to be kept in separate bank account: As per Clause (10) of Part I of Second Schedule to the Chartered Accountant Act, 1949, a Chartered Accountant in practice will be deemed to be guilty of professional misconduct if he fails to keep moneys of his client other than the fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.

The term reasonable time would depend upon the circumstances of the case. Moneys which are intended to be spent within a reasonably short time need not be put in a separate bank account.

Thus, in the instant case, Mr. Z should have kept the balance money after remitting the first instalment of advance tax into a separate bank account. Hence he is guilty of professional misconduct as per Clause (10) of Part I of Second Schedule of the Chartered Accountants Act, 1949.

(d) Failed to supply information called for: As per Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949, a member, whether in practice or not, will be deemed to be guilty of professional misconduct if he does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate authority.

Thus, in the given case, Mr. X has failed to reply to the letters of the Institute asking him to confirm the date of leaving the service as a paid assistant. Therefore, he is held guilty of professional misconduct as per Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949.

Question 12

Give your comments with reference to the Chartered Accountants Act, and schedules thereto:

(a) Mrs. Fair is a Director of XYZ Private Limited, having 15% share -holdings in the company. During 2003, the company appointed C.A. Mr. Lovely, Mrs. Fair's spouse, as its statutory auditor. On Mr. Lovely's advice, the company issued fresh equity shares in 2003-04, in the ratio of one share for every two shares held by the shareholders of the company. Mr. Lovely used to deliver audit report for subsequent years without any comments or disclosures, thereupon.

(b) Mr. A, a Chartered Accountant was the auditor of 'A Limited'. During the financial year 2007-08, the investment appeared in the Balance Sheet of the company of ₹10 lakhs and was the same amount as in the last year. Later on, it was found that the company's investments were only ₹25,000, but the value of investments was inflated for the purpose of obtaining higher amount of Bank loan.

(c) An advertisement was published in a Newspaper containing the photograph of Mr. X, a member of the institute wherein he was congratulated on the occasion of the opening ceremony of his office.

(d) Mr. X, a Chartered Accountant and the proprietor of X & Co., wrote several letters to the Assistant Registrar of Co-operative Societies stating that though his firm was on the panel of auditors, no audit work was allotted to the firm and further requested him to look into the matter. *(4 Marks each, May, 2010)*

Answer

(a) Clause (9) of Part I of the First Schedule to the 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 (now Section 139 and 140 read with Section 141 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

As per Section 141(3)(f) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor of a company whose relative is a director or is in the employment of the company as a director or key managerial personnel. The definition of 'Relative' includes husband and wife.

In this case Mrs. Fair is a Director of XYZ Private Limited and the company has appointed Mr. Lovely, Chartered Accountant, Mrs. Fair's spouse, as its statutory auditor. Mr. Lovely should not accept the appointment as statutory auditor of the company, where his wife M is director. This is contravention of section 141 (3) (f) of the Companies Act, 2013.

Therefore, Mr. Lovely is liable for misconduct as per Clause (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(b) As per Part I of Second Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he, certifies or submits in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another chartered accountant in practice, under Clause (2); does not exercise due diligence, or is grossly negligent in the conduct of his professional duties, under Clause (7); or fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion, under Clause (8).

The primary duty of physical verification and valuation of investments is of the management. However, the auditor's duty is also to verify the physical existence and

valuation of investments placed, at least on the last day of the accounting year. The auditor should verify the documentary evidence for the cost/value and physical existence of the investments at the end of the year. He should not blindly rely upon the Management's representation.

In the instant case, such non-verification happened for two years. It also appear that auditors failed to confirm the value of investments from any proper source. In case auditor has simply relied on the management's representation, the auditor has failed to perform his duty.

Accordingly, Mr. A, will be held liable for professional misconduct under Clauses (2), (7) and (8) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

(c) As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means.

In the given case, Mr. X published an advertisement in a Newspaper containing his photograph on the occasion of the opening ceremony of his office. On this context, it may be noted that the advertisement which had been put in by the member is quite prominent. If soliciting of work is allowed, the independence and forthrightness of a Chartered Accountant in the discharge of duties cannot be maintained.

The above therefore amounts to soliciting professional work by advertisement directly or indirectly. Mr. X would be therefore held guilty under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(d) As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means.

In the given case, Mr. X, a Chartered Accountant and proprietor of M/s X and Co., wrote several letters to the Assistant Registrar of Co-operative Societies, requesting for allotment of audit work. In similar cases, it was held that the Chartered Accountant would be guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949. The writing of continuous letter to ascertain the reasons for not getting the work is quite alright but in case such either amount to request for allowing the work then Mr. X will be liable for professional misconduct.

Consequently, Mr. X would therefore be held guilty under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

Question 13

Comment with reference to the Chartered Accountants Act, 1949 and Schedules thereto:

(a) H, a Chartered Accountant in practice is a partner in 3 firms. On the personal Letter Heads of H, names/address of all the 3 firms are mentioned. (4 Marks, June 2009)

(b) D, who conducts the tax audit u/s 44AB of the Income Tax Act, 1961 of M/s ABC, a partnership firm, has received the entire audit fees of ₹ 25,000 in April, 2009 in respect of the tax audit for the year ended 31.3.2009. The audit report was, however, signed on 25.5.2009. (4 Marks, June 2009)

(c) M/s LMN, a firm of Chartered Accountants having 5 partners accepts an audit assignment of a newly formed private limited company for audit fees of ₹ 5,000. (5 Marks, June 2009)

(d) P, a Chartered Accountant in practice, accepts appointment as statutory auditor for LMN Pvt. Ltd. Q, brother of P has substantial interest in LMN Pvt. Ltd. (5 Marks, June 2009)

Answer

(a) Under clause (7) of part -1 of First Schedule, a CA in practice is deemed to be guilty of professional misconduct if he (i) advertises his professional attainments or services or (ii) uses any designation or expressions other than 'Chartered Accountant" on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a university established by law in India or recognized by the Central Government or a title indicating membership of the ICAI or of any other institution that has been recognized by the Central Government or may be recognized by the council.

Here there is no prohibition for printing names of all 3 firms on the personal letter heads in which a member holding certificate of practice is a partner. Thus, H is not guilty of any professional misconduct in the above case.

(b) As per Section 141(3)(d)(ii) of the Companies Act, 2013, a person who, or his relative or partner is indebted to the company, or its subsidiary, or its holding or associate company, or a subsidiary of its holding company, for an amount exceeding ₹ 5,00,000 then he is not qualified for appointment as an auditor of a company.

In the instant Case, D is appointed to conduct a tax audit u/s 44AB of the Income Tax Act, 1961. There is no such similar provisions in the Income Tax Act. Thus, D will still be able to do the audit and would not be disqualified. He also does not violate any provision of the CA Act, 1949 and schedules thereto.

(c) Prescribed minimum audit fee is recommendatory, not mandatory in nature. Therefore, acceptance of audit assignment by M/s LMN, a firm of Chartered Accountants having 5 partners of a newly formed private limited company for audit fees of ₹ 5,000 is not violation of any provisions.

Therefore M/s LMN will not be held liable for guilty of misconduct.

(d) As per clause (4) of part I of Second Schedule, a CA is deemed to be guilty of professional misconduct if he expresses his opinion on financial statements in which his firm or a partner has substantial interest. As per Council General Guidelines, 2008, the above restriction is also made applicable for relatives of the members.

Further, as per Section 141(3)(f) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor of a company whose relative is a director or is in the employment of the company as a director or key managerial personnel.

In the instant Case, since Q, a relative has a substantial interest in LMN Pvt. Ltd., P cannot conduct the audit and needs to vacate the office. Thus Q will be guilty of misconduct in terms of above clause.

Question 14

Loans were given out of the funds of an Employees Provident Fund to the employer company in contravention of the applicable rules. As the auditor of the said Provident Fund, M discloses the contraventions to the Trustees of the fund, but failed to do so to the members of the fund. Comment. *(5 Marks, June 2009)*

Answer

As per clause 5 of Part I of Second Schedule to the Chartered Accountants Act, 1949, 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).

Further, 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 the given Case, CA M has contravened clause (5) of part I of Second Schedule as it is the duty of a CA in practice to disclose material facts known to him so that the financial statement does not become misleading.

Further the auditor CA should disclose such facts to beneficiaries of a fund in applicable cases. Technically, appointment of an auditor could be done by a company through its directors, but in substance the auditor in such cases addresses to the beneficiaries just like he gives his report to the shareholders of a company.

Therefore, in the instant case Mr. M is found guilty of professional misconduct.

Question 15

Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules there to:

(a) CA X was appointed as the Auditor of ABC Ltd. for 2007-08. Since he declined to accept the appointment, the Board of Directors appointed CA Y as the auditor in the place of CA X, which was also accepted by CA Y.

(b) CA Z who is a leading Income Tax Practitioner and consultant in Jaipur is also trading in derivatives.

(c) CA D, a Chartered Accountant prepared a project report for one of his clients to obtain bank finance (long-term) of ₹ 50 lakhs from a Commercial Bank. Consequent to the sanction of the loan by the bank CA D raised a bill for his services @ 2% of the loan sanctioned.

(d) CA ZZ who conducted ABC audit of a marathi daily 'New Era' certified the circulation figures based on Management Information System Report (M.I.S Report) without examining the books of Account. *(4 Marks each, November, 2008)*

Answer

(a) Clause (9) of Part I of the First Schedule to the 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 (now Section 139 and 140 read with Section 141 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

Board can appoint the auditor in the case of casual vacancy under Sections 139(8)(i) and Section 139(6) of the Companies Act, 2013. The non-acceptance of appointment by CA. X does not constitute a casual vacancy to be filled by the Board. In this case, it will be deemed that no auditor was appointed in the AGM.

Further, as per Section 139(10) of the Companies Act, 2013 when at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company. The appointment of the auditor by the Board is defective in law.

Hence CA. Y is guilty of professional misconduct as per clause 9 of the First Schedule as he accepted the appointment without verification of statutory requirements.

(b) As per clause 11 of Part-I of First Schedule of the Chartered Accountants Act, 1949 (hereinafter referred as 'Act'), a Chartered Accountant 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 so to engage".

However, the Council has granted general permission to the members to engage in 12 specific occupation. In respect of all other occupations specific permission of the Institute is necessary.

In this case CA Z is engaged in the occupation of trading in derivatives which is not covered under the general permission.

Hence specific permission of the Institute has to be obtained otherwise he will be deemed to be guilty of professional misconduct under clause 11 of Part-I of First Schedule of the Act.

(c) Clause 10 of part I to First Schedule to the Chartered Accountants Act prohibits a Chartered Accountant in practice to charge, to offer, to accept or accept fees which are based on a percentage of profits or which are contingent upon the findings or results of such work done by him.

However, this restriction is not applicable where such payment is permitted by the Chartered Accountants Act, 1949. The Council of the Institute has framed regulation 192 which exempts certain professional services from the operation of clause 10.

The services rendered by CA. D are not covered under the said exemption and hence CA. D is liable for professional misconduct.

(d) According to clause 7 of Part-I of Second Schedule of Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he "does not exercise due diligence or is grossly negligent in the conduct of his professional duties".

In the instant case, CA ZZ did not exercise due diligence and is grossly negligent in the conduct of his professional duties since he certified the circulation figures without examining the books of accounts.

To ascertain the number of paid copies verification of remittances from the agents, credit allowed to the agents for unsold copies returned, examination of books of account is essential.

Further certification of circulation figures based on statistical information without cross verification with financial records amounts to gross negligence and failure to exercise due diligence.

Hence, CA ZZ is guilty of professional misconduct as per clause 7 of part I of Second Schedule of Chartered Accountants Act, 1949.

Question 16

Comment on the following with reference to the Chartered Accountants Act, 1949 as amended by the Chartered Accountants (Amendment) Act, 2006 and schedules thereto:

(a) As a Chartered Accountant in practice, you are asked to conduct a review of the "Profit Forecast" prepared by a Company in connection with its application for a Term loans from a bank. (4 Marks, May, 2008)

(b) X, a Chartered Accountant availed a loan against his shares held as investments from a nationalized bank. He issued 2 cheques towards repayment of the said loan. Both the cheques were returned back by the bank with the remarks "Refer to Drawer".

(5 Marks, May, 2008)

(c) BC & Co, a firm of Chartered Accountants, accepted an assignment for audit under State level VAT Act, without any prior communication with the previous auditor.

(4 Marks, May, 2008)

(d) M, a Chartered Accountant in practice, is the Statutory Auditor of S Ltd. for the year ended 31st March 2008. In January 2008, he was appointed as a Director in H Ltd., which is the holding Company of S Ltd. (5 Marks, May, 2008)

Answer

(a) Under Clause 3 of Part I of Second Schedule to The Chartered Accountants Act, 1949, a CA in practice is deemed to be guilty of professional misconduct if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast. "The guidance note on accountants' report on profit/financial forecast" provides that profit forecasts can be prepared or reviewed by a CA provided he discloses in his report the sources of information, the basis of forecasts and major assumptions involved and so long as he does not vouch for the accuracy of the forecast. Hence, the offer can be accepted if the above guidance note is complied with.

(b) A Chartered Accountant is expected to maintain the highest standard 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.

A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, if he is found guilty of any professional or "Other Misconduct".

As per Clause 2 of Part IV of the First Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be 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 his professional work.

The question whether a particular act or omission constitutes "other misconduct" should be based on fact and circumstances of each case.

Under Negotiable Instruments Act 1881, where any cheque drawn by a person for the discharge of any liability is returned by the bank unpaid, either for insufficiency of funds or the cheque amount exceeds the arrangements made by the drawer of the cheque, the drawer of such cheque shall be deemed to have committed an offence.

In the given case the cheque was dishonoured with the remark "refer to drawer". However, such dishonour need not necessarily be only due to insufficiency of funds.

If it is proved that the cheques were dishonoured due to insufficiency of funds, the CA would be held guilty of "other misconduct".

(c) As per Clause 8 of Part I of First Schedule to the CA Act 1949, a chartered accountant in practice is deemed to be guilty of professional misconduct if he accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been issued certificate under the Restricted Certificates Rules 1932, without first communicating with him in writing.

In the instant case, BC & Co. accepted VAT – audit under State Level Act, carried out by another firm of chartered accountants in the previous year, without prior communication with the previous auditor.

A communication is mandatory requirement for all types of audit, if the previous auditor is a chartered accountant. Hence, the firm is guilty of professional misconduct.

(d) In terms of clause 11 of Part I of the First Schedule to the CA Act, 1949, a CA in practice cannot engage (unless permitted by the council) in any business or occupation other than the profession of Chartered accountant, but he can be a director of a company wherein he or any of his partners is not interested in such company as auditor.

However, public conscience is expected to be ahead of law and the requirement of independence should be interpreted much more strictly. Members should thus not place themselves in position which would either compromise or jeopardise their independence.

In view of the above, an auditor of a subsidiary cannot be a director of a holding company as it will affect his independence.

Question 17

Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

(a) Mr. A, a practicing Chartered Accountant agreed to select and recruit personnel, conduct training programmes for and on behalf of a client. (5 Marks, November, 2007)

(b) XY & Co., a firm of Chartered Accountant having 2 partners X & Y, one in charge of Head Office and another in charge of Branch at a distance of 80 kms, puts up a name-board of the firm in both premises and also in their respective residences.

(5 Marks, November, 2007)

(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. (4 Marks, November, 2007)

(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.

(4 Marks, November, 2007)

Answer

(a) Under Section 2(2)(iv) of the Chartered Accountants Act, 1949, a member of the Institute shall be deemed "to be in practice" when individually or in partnership with Chartered Accountants in practice, he, in consideration of remuneration received or to be received renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice. Pursuant to Section 2(2)(iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services".

The definition of the expression "Management Consultancy and other Services" includes Personnel recruitment and selection. Personnel Recruitment and selection includes, development of human resources including designing and conduct of training programmes, work study, job description, job evaluation and evaluations of work loads.

So A is not guilty of professional misconduct.

(b) The council of the Institute has decided that with regard to the use of the name-board, there will be no bar to the putting up of a name-board in the place of residence of a member with the designation of chartered accountant, provided, it is a name-plate or board of an individual member and not of the firm. In the given case partners of X Y & Co., put up a name board of the firm in both offices and also in their respective residences.

Thus the chartered accountants are guilty of misconduct. Distance given in the question is not relevant for deciding.

(c) As per clause 5 of Part I of Second Schedule of the Chartered Accountant Act, 1949, 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, 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.

Question 18

Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

(a) A chartered accountant in practice created his own website in attractive format and colours and circulated the information contained in the website through E-mail.

(5 Marks, May, 2007)

(b) A chartered accountant in practice takes up the appointment as managing director of a public limited company. (4 Marks, May, 2007)

(c) S. a practicing chartered accountant gives power of attorney to an employee chartered accountant to sign reports and financial statements, on his behalf.

(5 Marks, May, 2007)

(d) A is the auditor of Z Ltd., which has a turnover of ₹200 crore. The audit fee for the year is fixed at ₹50 lakhs. During the year, the company offers A an assignment of management consultancy within the meaning of Section 2(2)(iv) of the CA Act, 1949 for a remuneration of ₹1 crore. A seeks your advice on accepting the assignment.

(4 Marks, May, 2007)

Answer

(a) Creation of own website by a chartered accountant/firm of chartered accountants The guidelines approved by the Council of the Institute of Chartered Accountants of India permits creation of own website by a chartered accountant in his or his firm name and no standard format or restriction on colours is there. The chartered accountant or firm, as per the guidelines, should ensure that none of the information contained in the website be circulated on their own or through E-mail or by any other mode except on a specific "Pull" request.

Since in the given case, the chartered accountant circulated the information contained in the website through E-mail, he is guilty of misconduct under clause 6 of Part I of the First Schedule to the Chartered Accountants Act, i.e., a chartered accountant in practice is deemed to be guilty of professional misconduct if he solicits client or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means.

(b) Appointment of a Chartered Accountant in practice as MD of a Public Limited Company: 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.

(c) Power of signing reports and financial statements: Under clause 12 of Part I of First Schedule to the Chartered Accountants Act, 1949, 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.

(d) Appointment as a statutory auditor of a PSUs'/Govt company(ies)/listed company(ies) and other public company(ies): As per the Council General Guidelines 2008, under Chapter IX on appointment as statutory auditor a member of the Institute in practice shall not accepts the appointment as a statutory auditor of a PSUs'/Govt company(ies)/Listed company(ies) and other public company(ies) having a turnover of ₹ 50 crores or more in a year and where he accepts any other work(s) or assignment(s) or service(s) in regard to same undertaking(s) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same undertaking. For this purpose the other work/services includes Management Consultancy and all other professional services permitted by Council excluding audit under any other statute, Certification work required to be done by the statutory auditor and any representation before an authority.

In view of the above position it would be a misconduct on A's part if he accepts the management consultancy assignment for a fee of ₹ 1 crore.

Question 19

Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

(a) Mr. Rahul, a locally based Chartered Accountant, accepted an audit assignment at a fee lower than that charged by the previous auditor, who was stationed in another town and had to spend a lot of money on travel for which he did not charge separately.

(4 Marks, November, 2006)

(b) The superannuation-cum-pension fund for the employees of a company was under a separate 'trust'. Both the company and the trust were under the same management. The auditor, who was auditing the accounts of the company as well as the trust noted some irregularities in the operation of the trust and commented upon these irregularities in the confidential report given to the trustees, but did not mention about these irregularities in his report on the Annual accounts of the Trust. *(5 Marks, November, 2006)*

(c) M/s XYZ a firm of Chartered Accountants received ₹2 lakhs in January, 2006 on behalf of one of their clients, who has gone abroad and deposited the amount in their Bank

account, so that they can return the money to the client in July, 2006, when he is due to return to India. (5 Marks, November, 2006)

(d) Mr. J.J. a practicing Chartered Accountant engages himself as part time finance manager of Quick Return Securities Ltd. He is of the view that as both functions are independent, he need not take permission from the Institute. (4 Marks, November, 2006)

Answer

(a) Undercutting of fees: In this case, Mr. Rahul is a locally based Chartered Accountant, accepted an audit assignment at a fee lower than that charged by the previous auditor, who was outstation based Chartered Accountant and had to spend a lot of money on travel which was included in his audit fee and was not charged by him separately. The motive of Mr. Rahul was not to get the work from previous auditor by accepting the audit assignment on lower fee i.e. undercutting of fee. Because, in considering whether variation in fees charged would constitute undercutting, the quantum of work; incidental and out of pocket expenses and other terms of appointment should be considered.

Since the previous auditor was stationed in another town and therefore, had to incur higher cost on account of conveyance, and the previously the fee was decided on a composite basis inclusive of travelling expenses of the auditor, it cannot be said that Mr. Rahul has accepted an audit assignment based on under cutting of fees. Hence, Mr. Rahul will not be held guilty for misconduct.

(b) Disclosure of material facts: A Chartered Accountant in practice is deemed to be guilty of professional misconduct under clause 5 of Part I of the Second Schedule if he "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". In this case, the Chartered Accountant was aware of the contraventions and irregularities committed by the trust as these were referred to in the confidential report given by the Chartered Accountant to the trustees of the company. However, he had issued the annual accounts without any qualification. On similar facts it was held by the Supreme Court in Kishorilal Dutta vs. P. K. Mukherjee that it was the duty of the Chartered Accountant to have disclosed the irregularities and contravention to the beneficiaries of the fund in the statement of accounts signed by him. Accordingly, in the present case also it has to be held that the Chartered Accountant is guilty of professional misconduct if the amount of irregularities is proved material.

(c) 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".

XYZ received the money in January, 2006 which is to be paid only in July 2006; hence it should be deposited in a separate bank account. Since in this case XYZ have failed to keep the sum of ₹ 2 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.

(d) Engaging in any business other than the profession of Chartered Accountants: Clause 11 of Part I of First Schedule of Chartered Accountants Act, 1949 states that a Chartered Accountant is deemed to be guilty of professional misconduct if he engages in any business other than the profession of Chartered Accountant unless permitted by the Council for the same.

In the given case Mr. J. J. a practicing Chartered Accountant is engaging himself as part time Finance Manager without the permission of the Institute which is misconduct attracted by clause II of Part I of First Schedule.

Question 20

Comment on the following with reference to the Chartered Accountants Act, 1949, Code of Ethics and Schedules to the Act:

(a) P, a Chartered Accountant in practice provides management consultancy and other services to his clients. During 2005, looking to the growing needs of his clients to invest in the stock markets, he also advised them on Portfolio Management Services whereby he managed portfolios of some of his clients. (5 Marks, May, 2006)

(b) B, a Chartered Accountant in practice is a partner in 3 firms. While printing his personal letter heads, B gave the names of all the firms in which he is a partner.

(4 Marks, May, 2006)

(c) XYZ & Associates, a firm with 5 partners developed a website www.xyzassociates.com. The website also contained a link to "All India Chartered Accountants Association", a voluntary association where X, a partner of the firm is currently the Vice-president.

(4 Marks, May, 2006)

(d) M/s LMN, a firm of Chartered Accountants responded to a tender from a State Government for computerization of land revenue records. For this purpose, the firm also paid ₹ 50,000 as earnest deposit as part of the terms of the tender. (5 Marks, May, 2006)

Answer

(a) Advising on Portfolio Management Services: The Council of the Institute of Chartered Accountants of India (ICAI) pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 has passed a resolution permitting "Management Consultancy and other Services" by a Chartered Accountant in practice. A clause of the aforesaid resolution allows Chartered Accountants in practice to act as advisor or consultant to an issue of securities including such matters as drafting of prospectus, filing of documents with SEBI, preparation of publicity budgets, advice regarding selection of brokers, etc. It is, however, specifically stated that Chartered Accountants in practice are not permitted to undertake the activities of broking, underwriting and portfolio management Services. Thus, a chartered accountant in practice is not permitted to manage portfolios of his clients.

In view of this, P would be guilty of misconduct under the Chartered Accountants Act, 1949.

(b) Advertisement of Professional Attainments: Clause 7 of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public. Even a member is not permitted to specify the date of setting up of practice or establishment of firm. However, there is no prohibition for printing names of all the three firms on the personal letterheads in which a member holding Certificate of Practice is a partner. Thus B is not guilty of any misconduct under the Chartered Accountants Act, 1949.

(c) Developing Website: As per the guidelines laid down under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 in respect of websites by chartered accountants in practice, it is permitted that website may provide a link to the website of ICAI, its Regional Councils, Branches and Government Departments and other professional Bodies like AICPA, ICAEW, CICA. In this case, M/s XYZ Associates provided a link to "All India Chartered Accountants Association" which is not permitted. Hence the firm would be liable for misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(d) 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 LMN can respond to tender as well as deposit ₹ 50,000 as earnest deposit and shall not have committed any professional misconduct.

Question 21

Comment on the following with reference to the Chartered Accountants Act, 1949 and Schedules thereto:

(a) Mr. S, a Chartered Accountant published a book and gave his personal details as the author. These details also mentioned his professional experience and his present association as partner with M/s RST, a firm. (5 Marks, November, 2005)

(b) Mr C accepted the statutory audit of M/s PSU Ltd., whose net worth is negative for the year 2003-04. The audit was to be conducted for the year 2004-05. The audited accounts for the year 2004-05 showed liability for payment of tax audit fees of ₹ 15,000 in favour of Mr E, the previous auditor. (5 Marks, November, 2005)

(c) M/s PQR, a firm of Chartered Accountants with 5 partners has accepted the audit of ABC Pvt. Ltd. for 2004-05 at an audit fee of ₹ 2,500. ABC Pvt. Ltd was incorporated in April, 2002, but had commenced operations in January, 2005. (4 Marks, November, 2005)

(d) Mr. P, a Chartered Accountant in practice entered into a partnership with Mr. L, an advocate for sharing of fees for work sent by one to the other. However, due to some disputes, the partnership was dissolved after 1 month without any fees having been received. (4 Marks, November, 2005)

Answer

(a) Soliciting Professional Work: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 refers to professional misconduct of a member in practice if he solicits client or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means. Therefore, members should not adopt any indirect methods to advertise their professional practice with a view to gain publicity and thereby solicit clients or professional work. Such a restraint must be practised so that members may maintain their independence of judgement and may be able to command the respect of their prospective clients. While elaborating forms of soliciting work, the Council has specified that a member is not permitted to indicate in a book or an article, published by him, the association with any firm of chartered accountants. In this case, Mr S a chartered accountant, published the book and mentioned his professional experience and his association as a partner with M/s RST, a firm of chartered accountants.

Mr. S being a chartered accountant in practice has committed the professional misconduct by mentioning that at present he is a partner in M/s. RST, a chartered accountants firm.

(b) Accepting Appointment as an Auditor: As per Chapter 7 of Council General Guidelines 2008 a member of the Institute of Chartered Accountants of India in practice shall be deemed to be guilty of professional misconduct if he accepts appointment as auditor of an entity in case the undisputed audit fee of another chartered accountant for carrying out the statutory audit under Companies Act or various other statutes has not been paid.

As per the proviso, such prohibition shall not apply in case of a sick unit where a sick unit is defined to mean "where the net worth is negative".

In the instant case, though the undisputed fees are unpaid, Mr C would still not be guilty of professional misconduct since the M/s PSU Ltd. is a sick unit having negative net worth for the year 2003-04.

(c) Minimum audit fee: Prescribed minimum audit fee is recommendatory, not mandatory in nature. Therefore, acceptance of audit assignment by M/s PQR, a firm of Chartered Accountants having 5 partners of ABC Pvt. Ltd. for audit fees of ₹ 2,500 is not violation of any provisions.

Therefore M/s PQR will not be held liable for guilty of misconduct.

(d) Partnership with non-chartered accountants: As per clause 4 of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant will be guilty of professional misconduct if he enters into partnership with any person other than a

chartered accountant in practice or a person resident without India who but for his residence abroad would be entitled to be registered as a member under Clause (v) of Sub-section (1) of Section 4 or whose qualification are recognized by the Central Government or the Council for the purpose of permitting such partnership.

This clause puts a restriction on entering into partnership with a non-chartered accountant for the practice of the profession of chartered accountancy. In the instant case since Mr. P, a chartered accountant, has entered into partnership with Mr. L, an advocate, he would be guilty of professional misconduct irrespective of the fact that no work or fee was shared and the partnership was dissolved after one month since the clause does not permit entering into partnership.

Question 22

Write short notes on Record of Audit Assignments (as required by ICAI regulations).

(4 Marks, November, 2005)

Answer

Record of Audit assignments: In exercise of the powers conferred by Chapter 8 of Council General Guidelines 2008, the Council of the Institute of Chartered Accountants of India specified that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the "specified number of audit assignments of the companies under Section 224 and /or Section 228 of the Companies Act, 1956 (Now under Section 141(3)(g) and 143 of the Companies Act, 2013). As a part of this clause, to meet its requirements, a Chartered Accountants in practice as well as a firm in practice shall maintain a record of the audit assignments accepted as laid out in guidelines issued by the Council of the ICAI under Part II of Second Schedule to the Chartered Accountants Act, 1949 in respect of ceiling on audits containing following particulars:

(i) Name of Company Audit/ Assignment.

(ii) Regn. No.

(iii) Date of appointment with Registrar of Companies.

(iv) Date of acceptance.

(v) Date on which form 23B filed (now Form ADT – 1 as per the provisions and rules made under Companies Act, 2013).

Question 23

Comment on the following with reference to the Chartered Accountants Act, 1949 and Schedules thereto:

(a) L, a chartered accountant did not maintain books of account for his professional earnings on the ground that his income is less than the limits prescribed u/s 44AA of the Income Tax Act, 1961. (5 Marks, May, 2005)

(b) M/s. ABC, a firm of Chartered Accountants has taken a loan for acquiring computers, from a company whose Managing Directors' son is an Articled Trainee with A, a partner of M/s ABC. (4 Marks, May, 2005)

(c) M/s XYZ, a firm of Chartered Accountants created a website "www.xyzindia.com". The website besides containing details of the firm and bio-data of the partners also contains the photographs of all the partners of the firm. (5 Marks, May, 2005)

(d) Z, a Chartered Accountant, certifies a financial forecast of his client which was forwarded to the client's bank based on which the bank sanctioned a loan to the client.

(4 Marks, May, 2005)

Answer

(a) Maintenance of Books of Account: As per the Council General Guidelines 2008, under Chapter 5 on maintenance of books of accounts, it is specified that if a chartered accountant in practice or the firm of Chartered Accountants of which he is a partner fails to maintain and keep in respect of his/its professional practice, proper books of account including the Cash Book and Ledger, he is deemed to be guilty of professional misconduct. Accordingly, it does not matter whether section 44AA of the Income Tax Act, 1961 applies or not. Hence, Mr. L is guilty of professional misconduct.

(b) Loan from a Company: As per Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949, a chartered accountant is deemed to be guilty of professional misconduct if he contravenes any of the provisions of Chartered Accountants Act, 1949 or Regulations made thereunder. Regulation 47 of the Chartered Accountant's Regulations, 1988, prohibits a member from accepting any premiums or loans or any deposit in any form from an articled clerk directly or indirectly. However, M/s ABC has taken loan from a company whose Managing Director happens to be father of articled clerk with Mr. A, a partner of M/s ABC. In this case, the articled trainee has no direct interest in that company. There has been a case wherein a chartered accountant was held guilty of professional misconduct because he took a loan from a firm in which the articled clerk and his father were both interested. But, in this case as per the facts, the articled trainee has no direct interest in the company. However, if relationship, direct or indirect, can be established in view of relationship of articled trainee with MD of the company, Mr. A of M/s ABC would be held liable for professional misconduct. Thus, M/s ABC would be guilty of professional misconduct under this clause if it is proved that the loan was related to the engagement of the articled clerk.

(c) Hosting Details on Website: As per detailed guidelines of the ICAI laid down in Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant of the firm can create its own website using any format subject to guidelines. However, the website should be so designed that it does not solicit clients or professional work and should not amount to direct or indirect advertisement. The guidelines of the ICAI to allow a firm to put up the details of the firm, bio-data of partners and display of a passport size photograph. In the case of M/s XYZ, all the guidelines seem to have been complied and there appears to be no violation of the Chartered Accountants Act, 1949 and its Regulations.

(d) Certification of Financial Forecast: Under Clause (3) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice is deemed to be guilty of professional misconduct if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner

which may lead to the belief that he vouches for the accuracy of the forecast. Accuracy does not refer to arithmetical accuracy. All forecasts are estimates based on certain assumptions duly evaluated on a consideration of various relevant factors and cannot be ascertained with accuracy. The Guidance Note on Accountants Report on Profit Forecasts and/or Financial forecasts considered the implications of this clause and made it clear that the chartered accountant can participate in the preparation of profit or financial forecasts and review them. But, first of all, he should clearly indicate in his report the sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts and, secondly, he should not vouch for the accuracy of the forecastes. In the instant case, Mr. Shankar is deemed to be guilty as it appears that he has certified the financial forecast without taking adequate safeguards.

Question 24

Do you approve of the following? If not, why?

(a) A firm of Chartered Accountants was appointed by a company to evaluate the costs of the various products manufactured by it for its information system. One of the partners of the firm was a Non-Executive Director of the company.

(b) Mr. Qureshi, Chartered Accountant, in practice died in a road accident. His widow proposes to sell the practice of her husband to Mr. Pardeshi, Chartered Accountant, for ₹ 5 lakhs. The price also includes right to use the firm name - Qureshi and Associates. Can widow of Qureshi sell the practice and can Mr. Pardeshi continue to practice in that name as a proprietor? (4 Marks each, November, 2004)

Answer

(a) Evaluation of Cost of Products: Clause 4 of Part I of the Second Schedule to Chartered Accountants Act, 1949, states that expressing an opinion on financial statements of any business or any enterprise in which the auditor, his firm or a partner in his firm has a substantial interest would constitute misconduct. Also, the Council of the Institute of Chartered Accountants of India has stated that in cases where a member of the Institute is a director of a company, or the firm in which the said member is a partner, should not express any opinion on its financial statements. As per facts of the case, the firm has been retained to evaluate the cost of products manufactured by it for its information system. It is a part of management consultancy service of the firm and moreover its partner was on the Board. Hence, the firm can perform this assignment and it will not constitute misconduct. However, the firm while accepting the position as auditor in future would have to consider whether it would be possible to act in independent manner and express opinion on financial statements.

(b) Sale of Goodwill: With reference to Clause (2) of Part I to the First Schedule to Chartered Accountants' Act, 1949, the Council of the Institute of Chartered Accountants of India had an occasion to consider whether the goodwill of a proprietary concern of chartered accountant can be sold to another member who is otherwise eligible, after the death of the proprietor. It lay down that the sale is permitted subject to certain conditions. It further resolved that the legal heir of the deceased member has to obtain the permission of the Council within a year of the death of the proprietor concerned. Thus, in a given case and on the facts, the widow of Mr. Qureshi, who has sold the practice for ₹ 5 lakhs is nothing but sale of goodwill. Thus the act of Mrs. Qureshi is permissible.

Question 25

Write short notes on Other Misconduct. (4 Marks, November, 2004)

Answer

Other Misconduct:

(i) A member is liable to disciplinary action under Section 21 of the Chartered Accountant Act if he is found guilty of any professional or 'other misconduct'.

(ii) Other misconduct has been defined in Part IV of First Schedule and Part III of Second Schedule in the CA (Amendment Act) 2006.

(iii) As per Part IV of First Schedule of the CA Act, a member of the Institute whether in practice or not, shall be deemed to be guilty of other misconduct if he -

1. Is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months.
2. 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 his professional work.

(iv) As per Part III of Second Schedule to the CA Act, a member of the Institute whether in practice or not shall be deemed to be guilty of other misconduct if he Is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term exceeding six months.

This provision empowers the Council to enquire any misconduct of a member even if it does not arise of professional misconduct.

Some illustrative examples, where a member may be found guilty of "Other Misconduct", under the aforesaid provisions rendering, himself unfit to be member are:

(i) Where a chartered accountant retains the books of account and documents of the client and fails to return these to the client on request without a reasonable cause.

(ii) Where a chartered accountant makes a material misrepresentation.

(iii) Where a chartered accountant uses the services of his articled or audit clerk for purposes other than professional practice.

(iv) Conviction by a competent court of law for any offence under Section 8(v) of the Chartered Accountants Act 1949.

(v) Misappropriation by office-bearer of a Regional Council of the Institute, of a large amount and utilisation thereof for his personal use.

(vi) Non-replying within a reasonable time and without a good cause to the letter of the public authorities.

(vii) Where certain assessment records of income tax department belonging to the client of Chartered Accountant were found in the almirah of the bed-room of the chartered accountant.

(viii) Where a chartered accountant had adopted coercive methods on a bank for having a loan sanctioned to him.

Question 26

Comment on the following with reference to Chartered Accountants Act, 1949 and schedules thereto:

(a) Mr. Parekh, a Chartered Accountant was invited by the Chamber of Commerce to present a paper in a symposium on the issues facing Indian Leather Industry. During the course of his presentation he shared some of the vital information of his client's business under the impression that it will help the Nation to compete with other countries at international level.

(b) Mr. Shah, a Chartered Accountant certified the financial statements of a company in which his wife is a Director holding substantial interest.

(c) Mr. Joe, a Chartered Accountant during the course of audit of M/s XYZ Ltd. came to know that the company has taken a loan of ₹ 10 lakhs from Employees Provident Fund. The said loan was not reflected in the books of account. However, the auditor ignored this information in his report.

(d) Mr. Jain, a Chartered Accountant certified the circulation of "Good Luck" a weekly magazine without examination of financial records and other required documents.

(e) A charitable institution entrusted ₹ 10 lakhs with its auditors M/s Ram and Co., a Chartered Accountant firm, to invest in a profitable portfolio. The auditors pending investment of the money, deposited it in their Savings bank account and no investment was made in the next three months. (4 Marks each, May, 2004)

Answer

(a) 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. Parekh 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.

(b) Disclosure of Substantial Interest: Clause (4) of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that if an auditor expresses his opinion on the financial statements of any business in which he, his firm or partner in his firm or his relative has substantial interest, he is committing professional misconduct. The Council also emphasizes that the aforesaid requirement of Clause (4) is equally applicable while performing all types of attest functions by the members. In the given case, Mr. Shah, Chartered Accountant, has certified the financial statements of a company in which his wife is a director with substantial interest. Hence this amounts to professional misconduct which attracts clause (4) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

(c) Failure to Disclose Material Facts: As per Clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered Accountant in practice will be held liable for misconduct if he fails to disclose a material fact known to him, which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading. In this case, Mr. Joe has come across information that a loan of ₹ 10 lakhs has been taken by the company from Employees Provident Fund. This is contravention of Rules and the said loan has not been reflected in the books of accounts. Further, this material fact has also to be disclosed in the financial statements. The very fact that Mr. Joe has failed to disclose this fact in his report, he is attracted by the provisions of professional misconduct under clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

(d) Failure to obtain information: Clause 8 of Part I of Second Schedule to Chartered Accountants Act, 1949 states that if a Chartered Accountant in practice fails to obtain sufficient information to warrant the expression of an opinion or his exceptions are sufficient material to negate the expression of an opinion, the chartered accountant shall be deemed to be guilty of a professional misconduct. Mr. Jain, a Chartered Accountant, certified the circulation figures of Good Luck, a weekly magazine without examination of financial records and other required documents. The chartered accountant should not express his opinion before obtaining the required data and information. As an auditor, Mr Jain ought to have verified the basic records such as print order, printer's bill, number of copies sold and paid for, number of copies returned unsold to ensure the correctness of circulation figures. Thus in the present case, Mr. Jain will be held guilty of professional misconduct.

(e) Failure to keep Money in separate Bank Account: If a Chartered Accountant in practice fails to keep moneys of his clients in a separate bank account or fails to use such moneys for purposes for which they are intended then his action would amount to professional misconduct under clause 10 of Part I of Second Schedule to the Chartered Accountants Act, 1949. In the course of his engagement as a professional accountant, a member may be entrusted with moneys belonging to his client. If he should receive such funds, it would be his duty to deposit them in a separate banking account, and to utilise such funds only in accordance with the instructions of the client or for the purposes intended by the client. In the given case by depositing the client's money by M/s Ram and Co., a firm of Chartered Accountants, in their own savings bank account, the auditors have committed a professional misconduct. Hence in the given case, M/s Ram & Co. will be held guilty of professional misconduct.