

PAPER – 3 : ADVANCED AUDITING

Answer Question Nos. 1 and 2 and four from the rest.

Question 1

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 Rs.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)

- (b) ABC Ltd. having a paid up capital of Rs. 1 crore earned as total net profit of Rs. 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 Rs. 20 lacs. The company also proposed in 2004-05 to declare dividend @25% out of accumulated profits. (4 Marks)

- (c) XYZ Ltd. had received a grant of Rs. 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)

- (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)

Answer

- (a) Stock Exchange Membership Rights: A Pvt. Ltd. has paid Rs.110 lacs for acquiring membership of stock exchange. Such membership rights provide exclusive right to A Pvt. Ltd. for carrying out stockbroking 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) Declaration of Dividends: ABC Ltd. earned a total net profit of Rs.1 crore for three years 2001-02 to 2003-04 but it did not declare any dividend nor transferred any amount to Reserves for these three years. Since it did not declare any dividend, there was no compulsion to transfer any amount to Reserves. It appears that the company has retained the profit of previous years as "surplus" under the heading of "Reserves & Surplus". ABC Ltd. wants to declare dividend of Rs. 25 lacs for the financial year 2004-05, which works out to 25% of its paid up capital. However, since this rate of dividend exceeds 20% of the paid up share capital, as per the requirements of Companies (Transfer of Profit to Reserves) Rules, 1975, the company should transfer at least 10% of its current profit that is Rs.2 lacs to reserves resulting into deficiency of Rs. 7 lacs in the amount of current profit which could be available for the purpose of distribution of dividend.

The company, however, is well within its power to cover the said deficiency of profit out of its accumulated profit inspite of restrictions laid down in the rules prescribed under section 205A (3) of the Act, viz., Companies (Declaration of Dividend out of Reserves) Rules, 1975, since the company had not transferred any of its profit for the years 2001-2002 to 2002-04 to reserves. Thus, the company is well within its powers and right to declare the dividend of Rs.25 lacs for the year 2004-05.

- (c) Refund of Government Grant: As per facts of the case, XYZ Ltd. had received a grant of Rs. 50 lacs in 1997 from a State Government towards installation of pollution control machinery on fulfillment 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 a 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 2

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)
- (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)
- (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)
- (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 Rs.50,000 as earnest deposit as part of the terms of the tender.* (5 Marks)

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 CAs 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 Rs.50,000 as earnest deposit and shall not have committed any professional misconduct.

Question 3

Answer the following:

- (a) *Designing an Audit Strategy is the backbone of the "Audit Planning" process. Discuss.*
(10 Marks)
- (b) *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)

Answer

- (a) Audit strategy is concerned with designing optimised audit approaches, that seeks to achieve the necessary audit assurance at the lowest cost within the constraints of the information available. The formulation of audit strategy as shall be evident from the process as explained in the following paragraphs in fact shall form the basis of audit planning to achieve the audit objectives in the most efficient and effective manner. Audit strategy generally involves the following steps:
- (i) **Obtaining Knowledge of Business:** AAS 20, "Knowledge of Business", 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.

- (b) 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 4

Answer the following:

- (a) 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)

- (b) *What are the special points in the audit of a Non-Banking Equipment Leasing Finance Company?* (8 Marks)

Answer

- (a) 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. AAS 24, "Audit Considerations Relating to Entities Using Service Organisations", while planning the audit, the auditor of the client should determine the significance of the activities of the service organisation to the client and their relevance to the audit. In doing so, the auditor of the client would need to consider the following, as appropriate:
- Ø Nature of the services provided by the service organisation.
 - Ø Terms of contract and relationship between the client and the service organisation.
 - Ø The material financial statement assertions that are affected by the use of the service organisation.
 - Ø Inherent risk associated with those assertions.
 - Ø Extent to which the client's accounting and internal control systems interact with the systems at the service organisation.
 - Ø Client's internal controls that are applied to the transactions processed by the service organisation.
 - Ø Service organisation's capability and financial strength, including the possible effect of the failure of the service organisation on the client.
 - Ø Information about the service organisation such as that reflected in user and technical manuals, if any.
 - Ø Information available on general controls and computer systems controls relevant to the client's applications.

The auditor of the client would also consider the availability of third-party reports from service organisation's auditors, internal auditors, or regulatory agencies as a means of providing information about the accounting and internal control systems of the service organisation and about its operation and effectiveness.

- (b) Special Points in the Audit of Non Banking Equipment Leasing Finance (NBELF) Company:
- (i) Ascertain whether the 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 periodic physical verification. In respect of some major transactions, an auditor should 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 whether the NBFC has an adequate system for monitoring whether the assets have been adequately insured against and regular maintenance of the leased assets 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 AS 13 issued by the Institute of Chartered Accountants of India in respect of "Accounting for Investments" has been complied with.

Question 5

Answer the following:

- (a) 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)
- (b) As a tax auditor, how would you report on the following:
- (i) Labour charges paid on which tax is deducted at source at an inappropriate rate. (4 Marks)
 - (ii) Capital expenditure incurred for Scientific Research Assets. (4 Marks)

Answer

- (a) 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 prenumbered.
 - (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 supportings (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.
- (b) (i) Section 40(a) 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 or 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 during the previous year or in the subsequent year before the expiry of the time prescribed under sub-section (1) of section 200, shall not be deducted in computing the income. Therefore, if tax is deducted at an inappropriate rate, the amount is disallowable u/s 40(a)(ia) of the Income-tax Act. This fact needs to be reported in Clause 17(f) of Form 3CD where all amounts inadmissible u/s 40(a) are 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 17(f) of Form 3CD.
- (ii) Clause 15(a) and (b) of Form 3CD requires that expenditure on Scientific Research (capital as well as revenue) covered u/s 35 of the Income-tax Act, 1961 reported of the amount debited to the profit and loss account (showing the amount debited and deduction allowable and not debited to the profit and loss account. Accordingly, the auditor should exercise his judgement and accordingly report in Clause 15(b) the amount of capital expenditure not debited to the Profit and Loss Account which is eligible for deduction u/s 25 as Scientific Research Expenditure.

Question 6

Answer the following:

- (a) *Discuss the various aspects to be considered by the Statutory Auditor before qualifying his report.* (8 Marks)

- (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)
 - (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)

Answer

- (a) Aspects to be Considered Before Qualifying the Audit Report: AAS 28, "The Auditor's Report on Financial Statements", 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:
- (i) there is a limitation on the scope of the auditor's work; or
 - (ii) 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.

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 audits under the Companies Act, 1956, the auditor may also see whether the matters constituting the qualification involve a material contravention of any requirements of the Companies Act, 1956 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 being "subject to" or "except for" the effects of the matter to which qualification related.

- (b) Reporting under CARO, 2003
- (i) O Pvt. Ltd. is a dealer in shares and securities. Clause (xiv) of CARO, 2003 is applicable to a company in case it is dealing or trading in shares, securities, debentures and other investments. The requirements applicable to O Pvt. Ltd. would be as under:
 - whether proper records are maintained for transactions and contracts;
 - whether timely entries are made in such records; and
 - whether shares, securities, debentures and other investments have been held by the company in its own name except to the extent of exemption, if any granted under section 49 of the Companies Act, 1956.

In case auditor is satisfied in respect of aforesaid matters, after making examination, the auditor may report as under:

"In our opinion, and according to information and explanation given to us, the company has been maintained proper records in respect of transactions and contracts in securities during the year and timely entries have been made therein. Further, all shares and certificates are held by the company in its own name."

- (ii) In the case of ABC Pvt. Ltd. If purity of gold is not properly disclosed on the jewellery it amounts to defrauding the customers. That means the management is deceiving customers to obtain an illegal advantage. However, the auditor is concerned with fraudulent acts that cause a material misstatement in financial statements. As long as books of account are not falsified arising out of difference in the purity of gold, i.e., actual cost of the gold and the sale price of gold, it has no implication for the auditor. Further, under CARO, 2003, the auditor may examine this from the view point of maintaining proper records of inventory. But even the requirement of maintaining proper records does not necessitate that purity as such should be mentioned on the gold itself. However, the purity of gold would have implication on the valuation of inventory. But this aspect is not required to be reported under CARO, 2003.

Thus, from the view point of reporting on frauds under CARO, 2003, there is no implication for misstatement in the financial statements. Hence, no reporting is necessary for non-proper disclosure of purity of gold on the jewelry.

Question 7

Answer the following:

- (a) *Elaborate how the Statutory Auditor can verify the existence of related parties for the purpose of reporting under Accounting Standard 18. (8 Marks)*
- (b) *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)*

Answer

- (a) **Verification of Existence of Related Parties:** Related Parties (for AS 18), the auditor should adopt audit procedures laid down in AAS 23, "Related Parties", to identify the existence of such parties. The auditor should review information provided by the management of the entity, identifying the names of all known related parties and should perform the following procedures in respect of the completeness of this information:
- (a) review his working papers for the prior years for names of known related parties;
 - (b) review the entity's procedures for identification of related parties;
 - (c) inquire as to the affiliation of directors and key management personnels, officers with other entities;

- (d) review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a list of principal shareholders from the share register;
- (e) review memorandum and articles of association, minutes of the meetings of shareholders and the board of directors and its committees and other relevant statutory records such as the register of directors' interests;
- (f) inquire of other auditors of the entity as to their knowledge of additional related parties and review the report of the predecessor auditors;
- (g) review the entity's income tax returns and other information supplied to regulatory agencies; and
- (h) review the joint venture and other relevant agreements entered into by the entity.

If, in the auditor's judgement, the risk of significant related parties remaining undetected is low, these procedures may be reduced or modified as appropriate.

- (b) **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. 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 8

Write short notes on (any four):

- (a) *Remuneration to Statutory Auditors under the Companies Act, 1956.*
- (b) *Disclosure under "Basis of Issue Price" in prospectus.*
- (c) *Deferred Taxation*
- (d) *Sampling Risk*
- (e) *Test Packs*

(4 × 4 = 16 Marks)

Answer

- (a) *Remuneration to Statutory Auditors under the Companies Act, 1956*: The company auditor's remuneration is fixed by:
 - (i) directors when the first auditors are appointed or to fill a casual vacancy (other than the one caused by resignation of the auditor);
 - (ii) Central Government when the appointment is made by it; and
 - (iii) company in general meeting or in such other manner as the company in General meeting may determine (including those wherein the auditor is appointed by the C&AG of India u/s 619 of the Act.)

It is further provided that any sums paid by the company in respect of the auditor's expenses shall be deemed to be included in the expression 'remuneration'. This implies that where a fixed sum is approved as remuneration of the auditor, it includes his expenses. However, it is not necessary that the amount of remuneration is specified by the company in its general meeting. It would be enough if the manner in which the remuneration is to be fixed is laid down in the general meeting. It is also not essential that the remuneration is fixed in the same general meeting in which the auditor is appointed.

Disclosure Requirements Under Companies Act, 1956: As per the Profit and Loss Account under Schedule VI to the Companies Act, 1956, the remuneration may be disclosed to the auditors in the following manner:

- (a) As auditor
- (b) As adviser or in any other capacity in respect of:
 - (i) taxation matters

- (ii) Company Law Matters, and
 - (iii) Management Services
- (c) The amounts paid in any other manner.
- (b) Disclosures under 'Basis of Issue Price': Under this heading, the following information is to be disclosed:
 - (i)
 - (a) Earnings per share, i.e., EPS pre-issue for the last three years (as adjusted for changes in capital);
 - (b) P/E pre-issue and comparison thereof with industry P/E where available (giving the source from which industry P/E has been taken);
 - (c) Average return on net worth in the last three years;
 - (d) Minimum return on the increased net worth required to maintain pre-issue EPS;
 - (e) Net Asset Value per share based on last balance sheet;
 - (f) Net Asset Value per share after issue and comparison thereof with the issue price.
 - Provided that projective earnings shall not be used as a justification for the issue price in the offer document.
 - (ii) The accounting ratios disclosed in the offer document in support of basis of the issue price shall be calculated after giving effect to the consequent increase of 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.
- (c) 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).

- (d) **Sampling Risk:** Sampling Risk 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. The auditor is faced with sampling risk in both tests of control and substantive procedures as follows:

(a) *Tests of Control:*

- (i) *Risk of Under Reliance:* The risk that, although the sample result does not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.
- (ii) *Risk of Over Reliance:* The risk that, although the sample result supports the auditor's assessment to control risk, the actual compliance rate would not support such an assessment.

(b) *Substantive Procedures:*

- (i) *Risk of Incorrect Rejection:* The risk that, although the sample result supports the conclusion that a recorded amount balance or class of transactions is materially mis-stated, in fact it is not material mis-stated.
- (ii) *Risk of Incorrect Acceptance:* The risk that, although the sample result supports the conclusion that a recorded amount balance or class of transactions is no materially mis-stated, in fact it is materially mis-stated.

The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial statements than either the risk of under reliance or the risk of incorrect rejection.

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.

- (e) **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 invalid 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.
- (vi) If the results are identical, reliability of the computer programme is proved.