

PAPER – 3 : ADVANCED AUDITING

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

Question 1

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 Rs. 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 Rs. 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? (5 marks)
- (b) Kevin Industries Ltd. has a paid up capital of Rs. 20 crores divided into equity shares of Rs. 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 Rs. 10 crores and Rs. 15 crores respectively. The Earnings Per Share (EPS) disclosed in the financial statements for the above two years is Rs. 5.00 and Rs. 3.75 respectively. Is the disclosure correct? (5 marks)
- (c) 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)
- (d) A firm of a father and a son is receiving Rs. 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 are over Rs. 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)

Answer

- (a) **Subsequent Events:** Accounting Standard 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 of the company. As per AS 4, those events can be identified as adjustable events which provide further evidence of

conditions that existed at the balance sheet date; and non-adjustable events are those which are indicative of conditions that arise subsequent to the Balance Sheet Date. AAS 19 on "Subsequent Events" lays down that the "auditor should consider the effect of subsequent events on the financial statements and on the auditor's report". In the instant case, A Ltd. had a pending demand of Rs. 26 crores made by the Excise Department for which appeal was made in the Supreme Court. 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 Rs. 26 crores. 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	Profits	=	Adjusted EPS
	Adjusted No. of Shares		
	10,00,00,000		
As on 31.03.2004	4,00,00,000	=	Rs. 2.5
	Profits		
	No. of shares		
	15,00,00,000	=	EPS
	4,00,00,000		
			Rs. 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 227(3)(d) of the Companies Act, 1956.

- (c) **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 AAS 11, 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. "Representation by Management" 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.
- (d) **Related Party Transactions:** Accounting Standard 18, "Related Party Disclosures" applies to the facts of the case. AS 18 requires disclosure of party relationship and transactions between a reporting enterprise and its related parties. The 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 decisions. As per the explanation given in AS 18, significant influence is said to exist in case the investing party has 20% or more voting power in the enterprise. In the instant case, the managing director of XYZ Ltd. is a partner in the firm with his son which has been paid Rs. 2 lakhs as job work charges. The managing director is having a substantial holding in the firm. The case is squarely covered by AS 18. The approach of the managing director is not tenable under the law and accordingly all disclosure requirements have to be complied. Accordingly, the approach followed by the Managing Director is not right. Under the circumstances, the auditor shall have to modify his report. Also it has to be seen whether section 299 regarding disclosure of interest by interested directors has been complied with. If it is not complied with, the auditor needs to modify the report appropriately.

Question 2

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.* (4 marks)

- (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 Rs. 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)
- (c) *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.* (4 marks)
- (d) *Big Ltd. has borrowed Rs. 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 Rs. 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 Rs. 4 lakhs and add it to the cost of investments.* (4 marks)

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, unless he discloses the interest also in his report. 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 laid 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 Rs. 5 lakhs is nothing but sale of goodwill. Thus the act of Mrs. Qureshi is permissible.

- (c) **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.
- (d) **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. Rs. 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 profit and loss account. The effect of the same on the profits for the year would also have to be mentioned.

Question 3

- (a) *What are ‘Initial Audit Engagements’?* (2 marks)
- (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)
- (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)

Answer

- (a) **Initial Engagement – Opening Balances:** As per AAS 22 ‘Initial Engagements - Opening Balances’ initial audit engagements mean:
- (i) When the auditor is engaged to carry out the audit of financial statements of an entity for the first time; or.

- (ii) When the financial statements of the entity for the preceding period were audited by another auditor;

The situation mentioned in (ii) above arises whenever there is a change of auditor. The situation mentioned in (i) above is obviously when the auditor is appointed to take up the audit for the first time or no audit was carried out of the financial statements of the entity for the immediately preceding period.

(b) (i) Financial Statements Audited by Another Auditor – Audit Procedure:

- (a) Ordinarily the current auditor can place reliance on the closing balances contained in the audited financial statements of the preceding period. Sufficient audit evidence will be obtained for verifying opening balances, which are closing balances of the earlier period by perusing the copies of the audited financial statements.
- (b) If during the performance of audit for the current period the possibility of misstatements in opening balances is indicated, some indirect audit evidence can be obtained as part of the audit procedures performed during the current period. For example, the collections and payments of opening balances in the accounts of debtors and creditors respectively during the current period will provide evidence as to their existence, correctness and valuation at the beginning of the period.

- (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 after performing the laid down procedure in AAS 22, “Initial Engagements - Opening Balances”, the auditor is not satisfied in either of the above situations, he should, as appropriate express a qualified opinion or disclaimer of opinion. At times, it is also likely that the auditor opines that the profit and loss account is qualified but balance sheet is found to be unqualified. If the opening balances contain misstatements which materially affect the financial statements for the current period and the effect of the same is not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.

Question 4

- (a) *Enumerate the ‘Basic Elements of Audit Report’ as enshrined in AAS-28. (8 marks)*

(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)

(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)

Answer

(a) **Basic Elements of Auditor's Report:** As per AAS 28, "The Auditor's Report on Financial Statements", the auditor's report includes the following basic elements:

1. **Title:** It is appropriate to use the term "Auditor's Report" in the title so as to distinguish the same from other reports, e.g., Board of Directors' Report, etc.
2. **Addressee:** Ordinarily, the auditor's report is addressed to the authority appointing the auditor.
3. **Opening or Introductory Paragraph:** The auditor's report should identify the financial statements of the enterprise that has been audited including the date of and period covered by the financial statements. This introductory paragraph must state that the preparation of financial statements is the responsibility of the management and that the auditor's responsibility is to express an opinion based on audit.
4. **Scope Paragraph:** The auditor's report should describe the scope of the audit stating that the audit was conducted in accordance with auditing standards generally accepted in India. It must also lay down briefly the work performed by the auditor and the constraints involved in discharge of his attest function.
5. **Opinion Paragraph:** This paragraph is mainly devoted for expression of opinion as to whether the financial statements give a true and fair view and whether they comply with the statutory requirements.
6. **Date of Report:** The date of an auditor's report on the financial statements is the date on which the auditor signs the report expressing an opinion on the financial statements. The date of report informs the reader that the auditor has considered the effect on the financial statements and on the report of the events and

transactions of which the auditor became aware and that occurred up to that date. Since the auditor's responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the report earlier than the date on which the financial statements are signed or approved by management.

7. *Place of Signature*: The report should name specific location, which is ordinarily the city where the audit report is signed.
 8. *Auditor's Signature*: The report should be signed by the auditor in his personal name. Where the firm is appointed as the auditor, the firm name should also be mentioned. The proprietor or partner signing the report should also mention his membership number.
- (b) (i) **Opening Paragraph**: The opening or introductory paragraph identifies the financial statements of the entity that have been audited, including the date of and period covered by 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.

Question 5

- (a) *State the specific problems, which may arise in the implementation of internal control in an EDP system.* (8 marks)
- (b) *What are the characteristics of 'On-line Computer System'?* (4 marks)
- (c) *Explain : Tagging and Tracing* (4 marks)

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, separate individuals are responsible for initiating transactions, recording transactions, and custody of assets. As a basic control, separation of duties prevents or detects errors and irregularities. In a computer system, however, the traditional notion of separation of duties does not always apply. For example, a program may reconcile a vendor invoice against a receiving document and print a cheque for the amount owed to a creditor. Thus, the program is performing functions that in a manual systems would be considered incompatible. In minicomputer and PC environments, separation of incompatible functions may be even more difficult to achieve. Some minicomputers and PCs allow users to change programs and data easily; furthermore, they provide no record of these changes. If the minicomputer or PC does not have an inbuilt capability to provide a secure record of changes, it may be difficult to determine whether incompatible functions have been performed by systems users.
 - (ii) **Delegation of authority and responsibility:** A clear line of authority and responsibility is an essential control in both manual and computer systems. In a computer system, however, delegating authority and responsibility in an unambiguous way may be difficult because some resources are shared among multiple users. For example, one of the objectives of using a database 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 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 organizations have attempted to overcome these problems by designating a single user as the owner of data. This user assumes ultimate responsibility for the integrity of the data.
 - (iii) **Competent and trustworthy personnel:** The technology of data processing is now exceedingly complex-much more complex than in the days of manual systems. Highly skilled personnel are needed to develop, modify, maintain, and operate today's computer systems. Thus, the existence of competent and trustworthy personnel becomes even more important when computer systems are used to process an organization's data, since a relatively small number of individuals assume major responsibility for the integrity of the data.
 - (iv) **System of authorizations:** Management issues two types of authorizations to execute transactions. General authorizations establish policies for the organization to follow: for example, a fixed price list is issued for personnel to use when products are sold. Specific authorisations apply to individual transactions: for example, acquisitions of major capital assets may have to be approved by the board of directors. In a 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. For example, the order entry module in a sales system may determine the price to be charged to a customer. Thus, when evaluating the adequacy of authorisation procedures, auditors have to examine not only the work of employees but also the veracity of program processing.

- (v) **Adequate documents and records:** In a manual system, adequate documents and records are necessary to provide an audit trail of activities within the system. In computer systems, documents may not be used to support the initiation, execution and recording of some transactions. For example, in an on line order entry system customers orders received by telephone may be entered directly into the system. Similarly, some transactions may be activated automatically by a computer system: For example, an inventory replenishment program may initiate purchase orders when stock levels fall below a set amount. Thus, no visible audit or management trail may be available to trace the transaction. The absence of a visible audit trail is not a problem for the auditor provided that systems have been designed to maintain a record of all events and there is a means of accessing these records. In well-designed computer systems, audit trails are often more extensive than those maintained in manual systems.
- (vi) **Physical control over assets and records:** Physical control over access to assets and records is critical in both manual systems and computer systems. Computer systems differ from manual systems, however, in the way they concentrate the data processing assets and records of an organization. For example, in a manual system, a person wishing to perpetrate a fraud may be maintained at a single site-the data processing installation. Thus, the perpetrator does not have to go to physically distance locations to execute the fraud.
- (vii) **Adequate management supervision:** In a manual system management supervision of employee activities is relatively straight forward because managers and employees are often at the same physical location. In computer systems, however, data communications may be used to enable employees to be closer to the customers they service. Thus, supervision of employees may 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 inquiry.
- (viii) **Comparing recorded accountability with assets:** Periodically, data and the assets that the data purports to represent should be compared to determine whether incompleteness or inaccuracies in the data exist or shortages in the assets have occurred. In a manual system, independent staff prepares the basic data used for comparison purposes. In a computer system, however, programs are used to prepare this data. For example, programs may sort an inventory file by warehouse location and prepare counts by inventory item at different warehouses. If

unauthorized modifications occur to the programs or data files that the programs use, an irregularity may not be discovered.

(b) Characteristics of 'On-line Computer 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 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.
- (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 Rs.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 necessarily 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.

Question 6

- (a) *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)*
- (b) *Miranda Spinning Mills Ltd. is a sick company and has accumulated losses of Rs. 10 crores. The company has Rs. 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)*

Answer

- (a) 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/scrap 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.
- (b) **Application of Share Premium Account**: Section 78 of the Companies Act, 1956 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, the amount received as premium on such shares shall be transferred to an account called "Share Premium Account" and the provisions of the Companies Act, 1956 relating to reduction of share capital of a company except as provided in the section shall apply as if the share premium account was paid up share capital of the company. Sub-section (2) of the said section provides that notwithstanding anything contained in sub-section(1), share premium account may be applied by the company for issue of bonus shares, writing off of preliminary expenses of the commission paid or discount allowed on any issue of shares or debentures of the company or for paying the premium on redemption of preference shares or debentures of the company. In view of these provisions of the Companies Act, 1956, it is not permitted to adjust its accumulated losses against the share premium account.

Question 7

- (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)
- (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)
- (c) *State the procedure for verification of Agents' Balances in the course of audit of a General Insurance Company.* (4 marks)

Answer

- (a) **Appointment of Directors – Auditor's Duty:** As per section 274(1)(g) of the Companies Act, 1956, a person is disqualified to be appointed as a director in case such person is a director of a public company which has not filed the annual accounts for any continuous period of three years; or such company has failed to repay its deposits or interest thereon on due date or pay dividend and such failure continues for one year or more.

Section 227(3)(f) of the Companies Act, 1956 requires the statutory auditor to state whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274. Further, the Department (now Ministry of Company Affairs) has also issued the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003. Rule 4 requires that the statutory auditors of both the appointing as well as the disqualifying company to:

- (i) report under section 227(3)(f) of the Act to the members of the respective companies as to whether any director is disqualified from being appointed as a director under clause (g) of section 274(1) of the Companies Act, 1956; and
- (ii) furnish a certificate every year as to whether on the basis of his examination of the books and records of the company, any director of the company is disqualified as a director or not.

The auditor is required to obtain written representation as to names of directors, particulars of appointment, default by the company, etc. As a part of audit procedures, the auditor is required to obtain the necessary information before giving his report. The auditor is required to obtain evidence in the form of written representation from a director in respect of each such company has not defaulted in terms of the section 274(1)(g). The written representation should also be noted and taken on record by the Board. The auditor should also verify the information provided by the management and direction from the information contained in the register mentioned u/s 303(1) of the Act. Accordingly, the auditor is required to report appropriately.

- (b) **Declaration of Interim Dividend:** Section 205 of the Companies Act, 1956 permits declaration of interim dividend. 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, compulsory transfers to reserves, bad debts and other contingencies, only then the proportion of profits which have to be distributed as interim dividend may be decided.

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. The balance had also to

be sufficient to transfer the relevant amounts to reserves. In such a case the auditor need not report anything. Moreover, if such balance was not available, the dividend could also be paid out of reserves. In the situation of dividends to be declared out of reserves, a maximum of only 10% dividend is allowed. 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.

(c) 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 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 be obtained from the management in this regard.

Question 8

Write short notes on any **four** of the following:

- (a) *Certificate for Special Purpose vs. Audit Report*
- (b) *Audit vs. Investigation*
- (c) *Sauda Book*
- (d) *Other Misconduct*
- (e) *Advantages of Cost Audit to Government*
- (f) *Principal Enactments Governing Bank Audit*
- (g) *Corporate Governance*
- (h) *Responsibility of Joint Auditors*

(4 × 4 = 16 marks)

Answer

- (a) 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. Government authorities may, under various statutes or notifications, require reports or certificates from auditors in support of statements or other information prepared by an enterprise. Reports or certificates on specific matters may also be required from auditors by an enterprise, for its own special purposes. These reports or certificates to specific requirements of the individual users is unlike a 'general purposes report' e.g. an auditor's report on financial statements which is intended for general use. 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, e.g., certification of export turnover, etc. On the other hand, when the reporting auditor gives the 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.

- (b) **Audit vs. Investigation:** 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. The object of auditing is to ensure that the financial statements are free and fair and not misleading or unreliable. The merit of auditing lies in its ability to pronounce in general terms whether the accounts are basically reliable or not and in accordance with the legal requirements and regulations applicable to the particular audit. Audit is not based on suspicion unless circumstances exist to arouse suspicion 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.

- (c) **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 datewise. This register contains all the transactions, which may be of any of the kind mentioned below :

- ◆ member's own business on the Exchange,
- ◆ member's business on the Exchange on behalf of clients,
- ◆ member's business with the clients on principal-to-principal basis,
- ◆ member's business with the members of other Stock Exchanges,
- ◆ member's business on behalf of his clients with the members of other Stock Exchanges, and
- ◆ spot transactions, etc.

- (d) **Other Misconduct:** 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". "Other Misconduct" has not been defined in the Act. This provision empowers

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. For example, a member who is found to have forged the will of a relative, would be liable to disciplinary action even though the forgery may not have been done in the course of his professional duty. Other misconduct would also relate to conviction by a competent court for an offence involving moral turpitude punishable with cause transportation or imprisonment to an offence not of a technical nature committed by the member in his professional capacity.

In the absence of a statutory definition of “other misconduct”, the question whether a particular act or omission constitutes “other misconduct” has to be decided on the facts and circumstances of each case. In this context, the judgement of the Supreme Court in “*Council of the Institute of Chartered Accountants of India and another vs B. Mukherjee*” acquires special significance. After examining the nature, scope and extent of the disciplinary jurisdiction, which can be exercised under the provisions of the Act, the Supreme Court observed as under:

“We therefore, take the view that, if a member of the Institute is found, *prima facie*, guilty of conduct, which, in the opinion of the Council renders him unfit to be a member of the Institute, even though such conduct may not attract any of the provision of the Schedules, it would still be open to the Council to hold an inquiry against the member in respect of such conduct and a finding, against him, in such an inquiry, would justify appropriate action being, taken by the High Court”.

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.
- (e) **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) It helps in the fixation of selling prices of essential commodities and thereby avoiding undue profiteering.
- (ii) In the case of cost plus contracts of Government, it helps to fix the price at reasonable level.
- (iii) It enables the Government to focus the attention on inefficient units.
- (iv) It enables the Government to lay down policies in favour of protecting certain industries.
- (v) It facilitates the settlement of disputes brought to the Government.
- (vi) It creates healthy competition in the industry.

(f) Principal Enactments Governing Bank Audit: There is an elaborate framework governing the functioning of banks in India. The whole of banking sector can be categorise into several sectors such as commercial banks, cooperative banks, foreign banks, etc. The principal enactments which govern the functioning of various types of bank are as under:

- (a) Banking Regulation Act, 1949;
- (b) Banking Companies (Acquisition of Transfer of Undertakings) Act, 1970;
- (c) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980;
- (d) State Bank of India Act, 1955;
- (e) State Bank of India (Subsidiary Banks) Act, 1959
- (f) Regional Rural Banks Act, 1976;
- (g) Companies Act, 1956; and
- (h) Cooperative Societies Act, 1912 or the relevant State Cooperative Societies Acts.

Besides, the above enactments, the provisions of Reserve Bank of India Act, 1934, also affect the functioning of banks. The Act gives wide powers to Reserve Bank of India to give directions to Banks; such directions also have considerable effect on the functioning of banks.

(g) 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. Based on this report, SEBI has by circular in February 2000 directed stock exchanges to amend the Listing Agreement between them and the entities whose

securities are listed on such stock exchanges and include a new Clause 49 in such Listing Agreement. 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.

Note: SEBI has revised Clause 49 vide its Circular dated October 29, 2004.

- (h) **Responsibility of Joint Auditors:** AAS-12 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, 1956. Main features of the said AAS 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.