

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) ABC Ltd. commenced construction of a flyover in Mumbai in January, 2004 under BOLT scheme. The same was completed in February, 2005. Due to seasonal heavy rains in July, 2004 in the area, the work on the flyover had to be suspended for 1 month. The company accordingly suspended borrowing costs of Rs. 12.50 lakhs for that month from capitalization. (5 Marks)
- (b) P Ltd. of whom you are the Statutory Auditor appoints M/s XYZ as Branch Auditors for one of its branches. M/s XYZ conducted the audit of the branch without visiting the branch and instead getting the books at the H.O. M/s XYZ has submitted their Branch Audit Report to you. (5 Marks)
- (c) LM Ltd. has 2 divisions L and M. The finished products of division L are transferred to division M where further processing is carried out before sale to customers. To achieve transparency and accountability between the divisions, division L raises an invoice on division M at cost plus normal margins. At the year end the unrealized profits on inter-division stocks are eliminated. However, the transfers are recorded at the invoice value as sales and purchases in the respective divisions for the purpose of preparing the Profit and Loss Account. Suitable disclosures, for this are given in the 'Notes to Accounts'. (5 Marks)
- (d) T Pvt. Ltd. is an unlisted closely held company with turnover less than Rs.50 crores. While finalizing the accounts, Mr. M the Director (finance) disputed the applicability of AS 20 to the company. (3 Marks)

Answer

- (a) **Capitalisation of Borrowing Costs:** Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for intended use or sale are interrupted. According to AS-16, "Borrowing Costs", capitalisation of such borrowing costs should be suspended during extended periods in which active development is interrupted. The standard, however, clarifies that capitalisation of borrowing costs is not suspended when a temporary delay is necessary as a part of the process or substantial technical and administrative work is being carried out. Thus, the test as to whether or not to capitalise the borrowing costs depends primarily upon the nature of interruption of activities during "extended periods".

In the instant case, it has been mentioned that the construction activity was interrupted due to seasonal rain and hence being regular feature. Though the rain was heavy, the period cannot be considered as an "extended period" leading to substantial delay in suspension of construction activities. Therefore, borrowing cost of Rs.12.50 lakhs

incurred by ABC Ltd. should be capitalized. Hence, suspension of capitalization by the company is not a correct treatment and statutory auditor should report accordingly.

- (b) **Branch Auditor's Report:** As per provisions of the Companies Act, 1956, the accounts of a branch office of a company are required to be audited either by the company's auditor or by any other person qualified for appointment as auditor of the company. It is not necessary for branch auditor M/s XYZ to visit the branch and conduct the audit only at branch's premises. It is a matter of professional judgement for the branch auditor to decide as to whether he needs to visit the branch. At the same time, the statutory auditor has the right to visit branch offices and to have access to the books of accounts and vouchers maintained at the branch office in this case.

In any case, the principal auditor i.e. the statutory auditor of Head Office P Ltd. is entitled to rely on the work of branch auditor unless there are special circumstances to make it essential for him to visit the branch and examine the books of account and voucher records. As per basic principles governing an audit, the principal auditor is entitled to rely upon the work performed by others provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. As per AAS 10, "Using the work of another auditor", the principal auditor is not required to evaluate professional competence because branch auditor happens to be member of ICAI. The statutory auditor is also required to deal with the Branch Auditor's report in the manner, he considers necessary. Therefore, the statutory auditor is required to deal with M/s XYZ's report in the manner it considers fit under the circumstances.

- (c) **Revenue Recognition:** As per the definition of the term "Revenue" in AS 9, "Recognition", revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them.

As per the clarification issued by ICAI, the use of the word "enterprise" in the above definition clearly implies that the transfers within the enterprise cannot be considered as fulfilling the definition of the term "revenue". Thus, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with AS 9. Further, in case of inter-divisional transfers, risks and rewards remain within the enterprise and also there is no consideration from the point of view of the enterprise as a whole. Thus, the recognition criteria for revenue recognition are also not fulfilled in respect of inter-divisional transfers.

In the instant case, therefore, LM Ltd cannot recognise inter-division transfers from L to M as sales and the same will have to be eliminated during finalisation. If not so done, the statutory auditor will have to qualify his report.

- (d) **Applicability of Accounting Standard:** AS 20, "Earning Per Share", came into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity

shares are listed on a recognised stock exchange in India. As such AS 20 does not mandate an enterprise, which has neither equity shares nor potential equity shares which are so listed, to calculate and disclose earnings per share, but, if that enterprise discloses earnings per share for complying with the requirements of any statute or otherwise, it should calculate and disclose earnings per share in accordance with AS 20. Part IV of Schedule VI to the Companies, Act, 1956, requires, among other things, disclosure of earnings per share. Accordingly, every company, which is required to give information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

Accordingly the company, T Pvt. Ltd should compute and disclose EPS according to AS 20. Therefore, the contention of Director (Finance) is incorrect. The auditor will have to ensure that EPS is disclosed as per AS 20 or else the auditor should appropriately modify the audit report.

Question 2

Comment on the following with reference to the Chartered Accountants Act, 1949 and Schedules thereto:

- (a) *Mr. S, a Chartered Accountant published a book and gave his personal details as the author. These details also mentioned his professional experience and his present association as partner with M/s RST, a firm.* (5 Marks)
- (b) *Mr C accepted the statutory audit of M/s PSU Ltd., whose net worth is negative for the year 2003-04. The audit was to be conducted for the year 2004-05. The audited accounts for the year 2004-05 showed liability for payment of tax audit fees of Rs.15,000 in favour of Mr E, the previous auditor.* (5 Marks)
- (c) *M/s PQR, a firm of Chartered Accountants with 5 partners has accepted the audit of ABC Pvt. Ltd. for 2004-05 at an audit fee of Rs.2,500. ABC Pvt. Ltd was incorporated in April, 2002, but had commenced operations in January, 2005.* (4 Marks)
- (d) *Mr. P, a Chartered Accountant in practice entered into a partnership with Mr. L, an advocate for sharing of fees for work sent by one to the other. However, due to some disputes, the partnership was dissolved after 1 month without any fees having been received.* (4 Marks)

Answer

- (a) **Soliciting Professional Work:** Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 refers to professional misconduct of a member in practice if he solicits client or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means. Therefore, members should not adopt any indirect methods to advertise their professional practice with a view to gain publicity and thereby solicit clients or professional work. Such a restraint must be practised so that members may maintain their independence of judgement and may be

able to command the respect of their prospective clients. While elaborating forms of soliciting work, the Council has specified that a member is not permitted to indicate in a book or an article, published by him, the association with any firm of chartered accountants. In this case, Mr S a chartered accountant, published the book and mentioned his professional experience and his association as a partner with M/s RST, a firm of chartered accountants.

Mr. S being a chartered accountant in practice has committed the professional misconduct by mentioning that at present he is a partner in M/s. RST, a chartered accountants firm.

- (b) **Accepting Appointment as an Auditor:** As per notification issued by the Council under Clause (ii) of Part II of the Second Schedule, a member of the Institute of Chartered Accountants of India in practice shall be deemed to be guilty of professional misconduct if he accepts appointment as auditor of an entity in case the undisputed audit fee of another chartered accountant for carrying out the statutory audit under Companies Act, 1956 or various other statutes has not been paid.

As per the proviso, such prohibition shall not apply in case of a sick unit where a sick unit is defined to mean “where the net worth is negative”.

In the instant case, though the undisputed fees are unpaid, Mr C would still not be guilty of professional misconduct since the M/s PSU Ltd. is a sick unit having negative net worth for the year 2003-04.

- (c) **Accepting audit below certain fees:** Under Clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council has notified that if a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he on behalf of the firm in which he is a partner consisting of 4-8 partners with at least one partner holding a certificate of practice for five years or more accepts or carries out any audit work involving receipt of audit fees of an amount less than Rs.3,000 / Rs.5,000 depending on the population of the city in which it is located. It has been further provided that such a restriction shall not apply to audit of newly formed firms relating to 2 accounting years from the date of commencement of their operations.

In the instant case, though the audit fees of Rs.2,500/- less than that prescribed, but in view of the fact that operations have been commenced by the company M/s ABC Pvt. Ltd. only in January 2005, M/s PQR, chartered accountant, would not be hit by this notification and therefore, would not be guilty of any professional misconduct.

- (d) **Partnership with non-chartered accountants:** As per clause 4 of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant will be guilty of professional misconduct if he enters into partnership with any person other than a chartered accountant in practice or a person resident without India who but for his residence abroad would be entitled to be registered as a member under Clause (v) of sub-section (1) of section 4 or whose qualification are recognized by the Central Government or the Council for the purpose of permitting such partnership.

This clause puts a restriction on entering into partnership with a non-chartered accountant for the practice of the profession of chartered accountancy. In the instant case since Mr. P, a chartered accountant, has entered into partnership with Mr. L, an advocate, he would be guilty of professional misconduct irrespective of the fact that no work or fee was shared and the partnership was dissolved after one month since the clause does not permit entering into partnership.

Question 3

Answer the following"

- (a) *Enumerate (in brief) the basic principles governing an audit.* (5 Marks)
- (b) *Briefly explain the objectives of Operational Audit.* (5 Marks)
- (c) *While examining the going concern assumption of an entity, what important indications should be evaluated and examined?* (6 Marks)

Answer

- (a) AAS 1, "Basic Principles Governing an Audit", describes the basic principles which govern the auditor's professional responsibilities and which should be complied with whenever an audit is carried out. Basic principles are:
 - (i) **Integrity, Objectivity and Independence:** The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being compatible with integrity and objectivity.
 - (ii) **Confidentiality:** The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.
 - (iii) **Skills and Competence:** The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence in auditing.
 - (iv) **Work performed by others:** When the auditor delegates work to assistants or uses work performed by other auditor and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose.
 - (v) **Documentation:** The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.

- (vi) **Planning:** The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on a knowledge of the client's business.
- (vii) **Audit evidence:** The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.
- (viii) **Accounting System and Internal Control:** The auditor should reasonably assure himself that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal controls normally contribute to such assurance.
- (ix) **Audit conclusions and reporting:** The auditor should review and assess the conclusions drawn from the audit evidence obtain and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.

(b) Objectives of Operational Audit

The scope and quality of operational auditing is predominantly dependent upon management attitudes. An open minded management with broad vision, can appreciate the need of operational auditing and to give it the necessary freedom and sanction to perform what it is capable of performing. Also, the qualities and the sense of perspectives of the operational auditor can mould operational audit in the right shape. Therefore, there is a possibility of operational auditing having different objectives to fulfil in different considerations. Generally, operational audit objectives include:

- (i) **Appraisal of controls:** The most significant gain an organisation can derive from operational auditing is probably in the area of appraisal of controls. Internal controls, because of their unobtrusive omnipresence in the organisation, provide the essential hinges to ensure proper performance in each functional or organisational area for accomplishing the desired organisational objective.
- (ii) **Evaluation of performance:** In performance appraisal, the operational auditor is basically concerned not so much with how well technically the operations are going on, but with accumulating information and evidence to measure the effectiveness, efficiency and economy with which the operations are being carried on. The principal basis of performance evaluation can be productivity, personnel, workload, cost and quality. In the area of productivity, the operational auditor can undertake such tests as input-output ratios for materials and labour in quantitative terms.
- (iii) **Appraisal of objectives and plans:** Everything in an organisation is the product of basic plans and objectives set by the management. If the management policy favours installation of controls or specifies the extent of controls whether satisfactory or not, controls would have to stay within the policy frame. Therefore, the basic thing that should be evaluated is management policies, plans and objectives. Operational auditor may look into the aspects like whether objectives

are clearly spelt out and properly communicated to the personnel responsible for implementation and whether the personnel have understood the objectives in the sense meant by the management. Also, he can take note of any apparent conflict in the objectives for its effect on operations.

- (iv) **Appraisal of organisational structure:** Organisational structure provides the line of relationships and delegation of authority and tasks. This is an important element of the internal control design. Therefore, this is also another important area for appraisal by the operational auditor. In evaluating organisational structure, the aspects that may be considered by the operational auditor whether the organisational structure in conformity with management objectives and is drawn up on the basis of matching of responsibility and authority.
- (c) **Evaluating Going Concern Assumption:** AAS 16, "Going Concern", requires that while planning a performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements. In assessing such a risk, the auditor should examine the following indications.

I. Financial indications:

- ◆ Negative net worth or negative working capital
- ◆ Excessive use of short term borrowing for long term assets
- ◆ Fixed term borrowings approaching maturity without prospect of renewal or repayment.
- ◆ Adverse key financial ratio
- ◆ Substantial operating losses
- ◆ Substantial negative cash flow from operations
- ◆ Arrears or discontinuance of dividend payment
- ◆ Inability to pay creditors in time
- ◆ Default in compliance with loan agreements
- ◆ Change from credit to cash term with suppliers
- ◆ Inability to arrange finance for new development need
- ◆ Arrangement with creditors for reduction in liabilities

II. Operating Indications:

- ◆ Turnover and departure of key management personnel without replacement
- ◆ Loss of market, franchise, license or key supplier
- ◆ Labour difficulties or shortage of important supplies

III. Other indications:

- ◆ Non-compliance with statutory requirements
- ◆ Legal cases with possibility of adverse judgement which could not be met
- ◆ Changes in legislations or government policy
- ◆ Sickness of the entity under any statutory definition.

Question 4

Answer the following:

- (a) *What are the statements of facts that an auditor has to report u/s 227 of the Companies Act, 1956?* (4 Marks)
- (b) *Illustrate, as a statutory auditor, how would you give a report where all qualifications are not quantifiable.* (4 Marks)
- (c) *Under CARO, 2003 how, as a statutory auditor would you comment on the following:*
- (i) *Fixed assets comprising 1/3rd of the total assets have been disposed off during the year.* (4 Marks)
 - (ii) *A Term Loan was obtained from a bank for Rs.75 lakhs for acquiring R&D equipment, out of which Rs.12 lakhs was used to buy a car for use of the concerned director, who was overlooking the R&D activities.* (4 Marks)

Answer

- (a) Statements of Facts u/s 227 of the Companies Act, 1956: Section 227 of the Companies Act, 1956, deals with contents of the audit report. Some of these aspects on which the auditor is required to report which constitute statements of fact are as under:
- (i) Whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit.
 - (ii) Whether the report on the accounts of any branch office audited u/s 228 has been forwarded to him and how has he dealt with the same in preparing the auditor's report.
 - (iii) Whether the company's balance sheet and profit and loss account dealt with by his report are in agreement with the books of account.
 - (iv) Whether any director is disqualified from being appointed u/s 274(1)(g) of the Companies Act, 1956.
 - (v) Whether cess payable u/s 441A has been paid and if not, the details of amount not paid. (This clause has not yet become operative).
- (b) **An illustrative Format of Audit Report:** AAS 28 "The Auditor's Report on Financial Statements", states that there may be circumstances when it is not practicable to quantify the effect of modification in the audit report accurately, the auditor may do so on the

basis of estimates made by the management after carrying out such audit tests as are possible and clearly indicate the fact that the figures are based on management estimates. Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

The following illustration of a qualification where quantification was not possible will explain the point:

“(2) No provision has been made in respect of product warranties outstanding at the year end. The amount of provision required in this behalf could not be ascertained.”

In the above situation, the overall paragraph would appear as follows:

“We further report that, without considering item mentioned in paragraph (2) above, the effect of which could not be determined, had the observations made by us in paragraph (1) (not reproduced) and (2) above been considered, the profit for the year would have been Rs.500.41 lacs (as against the reported figure of Rs.596.07 lacs), reserves and surplus would have been Rs.685.43 lacs (as against the reported figure of Rs.781.09 lacs) and total fixed assets would have been Rs.200.00 lacs (as against the reported figure of Rs.229.05 lacs)”

Subject to the above in our opinion.....

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

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

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

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

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

Question 5

Answer the following:

- (a) *“Like every other audit, a systematic planning for cost audit is also necessary”. Indicate the matters to be included in a Cost Audit Programme.* (10 Marks)
- (b) *Enumerate some of the areas of concern in an audit of indirect taxes.* (6 Marks)

Answer

- (a) Matters to be included in Cost Audit Programme: It is a true statement that like any other audit a systematic planning for cost audit is also necessary. Therefore, the cost audit programme should include all the usual broad steps that a financial auditor includes in his audit programme. This would require that the various aspects like what to be done, when to be done and by whom to be done are adequately taken care of. However, looking to the basic difference in cost audit and financial audit as allocation and apportionment of expenses, statutory requirement etc. should require special consideration. Cost audit, in order to be effective, should be completed at one time as far as practicable. Based on above factors a set of procedures and instructions are evolved which may be termed the cost audit programme. Matters to be included in the Cost Audit Programme may be divided into following two stages:

- (i) Review of Cost accounting record: This will include:
- ◆ Method of costing in use
 - ◆ Method of accounting for raw material, stores and spares, wastage
 - ◆ System of recording wages, salary, etc.
 - ◆ Basis of allocation of overheads to cost centres and absorption by product and services
 - ◆ Treatment of expenses on finance, R&D, royalty, etc.
 - ◆ Method for depreciation accounting
 - ◆ Method of stocktaking and valuation
 - ◆ System of budgetary control

(ii) Verification of cost statement and other data: This will mainly cover:

- ◆ Licensed, installed and utilized capacity
- ◆ Operating and financial ratio
- ◆ Production data
- ◆ Consumption of material and actual expenses
- ◆ Sales realization
- ◆ Abnormal non-recurring and special cost
- ◆ Reconciliation with financial books

Some other factors which need to be brought into cost audit programme includes system of cost accounting, range of products, areas to be covered etc. indicating allocation of manpower and the time to be taken for computing the audit.

(b) Audit of Indirect Taxes: Same areas of concern in an audit of indirect taxes would be:

- (i) Non availment or short / excess availment of control or export incentives.
- (ii) Goods imported duty free or payment at concessional rates without properly complying with conditions.
- (iii) Valuation Issues – valuation not in line with customs rules.
- (iv) Applicability of the relevant control excise exemptions.
- (v) Valuation of goods not removed in normal course using valuation methods not in line with Central Excise Valuation Rules.
- (vi) Ignoring Liability under Service Tax on services provided or availed.
- (vii) Procedural non-compliance.
- (viii) Passing on of duty suffered on imported goods and of locally manufactured goods in excess of actual.

Question 6

Answer the following:

- (a) *As a tax auditor, which are the accounting ratios required to be mentioned in the report in case of manufacturing entities? Explain in detail any one of the above ratios and how does it help the tax auditor in his analytical review.* (8 Marks)
- (b) *What are the steps to be taken by an auditor for the audit of re-insurance ceded?* (8 Marks)

Answer

- (a) The ratios which are to be calculated for manufacturing entities are:
 - ◆ Gross profit / Turnover

- ◆ Net Profit / Turnover
- ◆ Stock-in-trade/Turnover
- ◆ Material consumed / Finished goods provided

Ratio analysis constitutes a substantive auditing procedure designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. Such assessment is necessary in organisation having large volumes of transactions and in the organisation following mechanised accounting system where it is not possible to check each and every transaction. It has the merit of bringing to focus the abnormal deviations and unexpected variations which the normal routine checking in auditing may fail to reveal. Ratios highlight only symptoms and that too as of a particular day and the auditor should study these symptoms properly, correlate them and reach definite conclusions or identify areas for further enquiries. The auditor should by relating sales with the net profit, various items of direct and indirect costs and gross profit gather information about the profitability and operating efficiency of an enterprise; variations in any of these ratios in a particular year should be inquired by the auditor. The fall in the gross profit ratio and profitability ratio should alert the auditor who should ask the management for the reasons thereof and which should be carefully examined by him. The auditor should by relating sales with the net profit, various items of direct and indirect costs and gross profit gather information about the profitability and operating efficiency of an enterprise; variations in any of these ratios in a particular year should be inquired by the auditor. The fall in the gross profit ratio and profitability ratio should alert the auditor who should ask the management for the reasons thereof and which should be carefully examined by him.

These ratios have to be given for the business as a whole and not product wise. While calculating these ratios, the tax auditor should assign a meaning to the terms used in the above ratios having due regard to the generally accepted accounting principles all the ratios mentioned in the clause are to be calculated in terms of value only.

The relationship of stock-in-trade to turnover over a period of time would reveal whether the entity has been accumulating stocks or there is a decline in the same. The auditor may obtain data for about 7-10 years, compute ratio of stock-in-trade/turnover and plot it on a graph paper over a period of time. This may give rise to several possibilities such as parallel horizontal lines, vertical rising line or a vertical falling line. A study of this relationship would reveal whether stocks are being accumulated or they are dwindling over a period. Such an information would provide an input to tax auditor as to whether figures of either stock or turnover are being manipulated. Sometimes, while studying the relationship, it may show sudden decline or increase at a point of time would reflect that there is definitely something wrong with the figures of stock. Therefore, a close examination of such ratios helps the tax auditor to focus on major deviations and consequently reasons for the same.

(b) Steps in Audit of Reinsurance ceded:

- (i) Evaluate internal control system in the area of reinsurance ceded to ensure determination of correct amount for reinsurance ceded, proper valuation of assets and liabilities arising out of reinsurance transaction and adherence to legal provisions and regulations.
- (ii) Ascertain whether adequate guidelines and procedures are established with respect to obtaining reinsurance.
- (iii) Reconcile reinsurance underwriting returns received from various units with the figures of premium, claims paid and outstanding claims for the company as a whole.
- (iv) Examine whether commission on reinsurance ceded is as per the terms of the agreement with the re-insurers.
- (v) Examine the computation of profit commission for automatic treaty arrangements in the light of the periodic accounts rendered and in relation to outstanding loss pertaining to the treaty.
- (vi) Examine whether loss recoveries have been claimed and accounted on a regular basis.
- (vii) Examine whether outstanding losses recoverable have been confirmed by re-insurers.
- (viii) Examine whether remittances to foreign re-insurers are as per foreign exchange regulations.
- (ix) Examine whether confirmations have been obtained regarding balances with re-insurers.
- (x) Review individual accounts of re-insurers to evaluate whether any provision/write off or write back is required.

Question 7

Answer the following:

- (a) *Your client is contemplating taking over a manufacturing concern and desires that in the course of due diligence review, you should look specifically for any hidden liabilities and overvalued assets.*

State (in brief) the major areas you would examine for the above. (8 Marks)

- (b) *Enumerate the risks and internal control characteristics in an audit conducted in Computer Information Systems (CIS) environment. (8 Marks)*

Answer

- (a) Due diligence is an all pervasive exercise to review all important aspects like financial, legal, commercial, etc. before taking any final decision in the matter. As far as any hidden liabilities or overvalued assets are concerned, this shall form part of such a

review. Normally, cases of hidden liabilities and overvalued assets are not apparent from books of accounts and financial statements. Review of financial statements does involve examination from the view point of extraordinary items, analysis of significant deviations, etc. However, in order to investigate hidden liabilities, the auditor should pay his attention to the following areas:

- ◆ Any show cause notice, which have not matured into demands but may be material and important.
- ◆ Contingent liabilities not shown in books
- ◆ Letters of comforts given to banks and financial institutions
- ◆ Company may have sold some subsidiaries / businesses and may have agreed to take over and indemnify all liabilities and contingent liabilities of the same prior to the date of transfer.
- ◆ Product and warranty liabilities, product returns & discounts, liquidated damages, etc.
- ◆ Tax liability under direct and indirect taxes.
- ◆ Long pending sales tax assessment.
- ◆ Cases of custom duty where only provisional assessment has been made and final assessment is yet to completed.
- ◆ Agreement to buy back shares at a stated price.
- ◆ Future lease liabilities.
- ◆ Claims against the company including third party claims.
- ◆ Unfunded retirement benefit of employees.
- ◆ Labour claims under negotiations.

Regularly Overvalued assets: The auditor shall have to specifically examine the following areas:

- ◆ Uncollectable receivables.
- ◆ Obsolete, slow and non-moving inventories and inventories valued above net realizable value, if any.
- ◆ Obsolete and unused plant and machinery and their spares.
- ◆ Assets value which have impaired due to sudden fall in market value.
- ◆ Assets shown in books above market value due to capitalization of expenditure / foreign exchange fluctuation or capitalisation of revenue expenditure.
- ◆ Assets under litigation.
- ◆ Investment shown at cost whose market value is much lower.
- ◆ Investment carrying very low rate of return.

- ◆ Infructuous project expenditure.
 - ◆ Intangibles of no value.
- (b) The risks and internal control characteristics in CIS environment as per AAS 29, "Audit in a Computer Information Systems Environment", include the following:
- ◆ *Lack of transaction trails:* Some computer information systems are designed so that a complete transaction trail that is useful for audit purposes might exist for only a short period of time or only in computer readable form. Where a complex application system performs a large number of processing steps, there may not be a complete trail. Accordingly, errors embedded in an application's program logic may be difficult to detect on a timely basis by manual (user) procedures.
 - ◆ *Uniform processing of transactions:* Computer processing uniformly processes like transactions with the same processing instructions. Thus, the clerical errors ordinarily associated with manual processing are virtually eliminated. Conversely, programming errors (or other systemic errors in hardware or software) will ordinarily result in all transactions being processed incorrectly.
 - ◆ *Lack of segregation of functions:* Many control procedures that would ordinarily be performed by separate individuals in manual systems may become concentrated in a CIS environment. Thus, an individual who has access to computer programs, processing or data may be in a position to perform incompatible functions.
 - ◆ *Potential for errors and irregularities:* The potential for human error in the development, maintenance and execution of computer information systems may be greater than in manual systems, partially because of the level of detail inherent in these activities. Also, the potential for individuals to gain unauthorised access to data or to alter data without visible evidence may be greater in CIS than in manual systems.

In addition, decreased human involvement in handling transactions processed by computer information systems can reduce the potential for observing errors and irregularities. Errors or irregularities occurring during the design or modification of application programs or systems software can remain undetected for long periods of time.

- ◆ *Initiation or execution of transactions:* Computer information systems may include the capability to initiate or cause the execution of certain types of transactions, automatically. The authorisation of these transactions or procedures may not be documented in the same way as that in a manual system, and management's authorisation of these transactions may be implicit in its acceptance of the design of the computer information systems and subsequent modification.
- ◆ *Dependence of other controls over computer processing:* Computer processing may produce reports and other output that are used in performing manual control procedures. The effectiveness of these manual control procedures can be dependent on the effectiveness of controls over the completeness and accuracy of

computer processing. In turn, the effectiveness and consistent operation of transaction processing controls in computer applications is often dependent on the effectiveness of general computer information systems controls.

- ◆ *Potential for increased management supervision:* Computer information systems can offer management a variety of analytical tools that may be used to review and supervise the operations of the entity. The availability of these analytical tools, if used, may serve to enhance the entire internal control structure.
- ◆ *Potential for the use of computer-assisted audit techniques:* The case of processing and analysing large quantities of data using computers may require the auditor to apply general or specialised computer audit techniques and tools in the execution of audit tests.

Question 8

Write short notes on (any **four**):

- (a) *Categories of Non-banking Finance Companies (NBFCs)*
- (b) *Recognition of Deferred Tax Assets*
- (c) *Valuation of Investments “held to maturity” by banks*
- (d) *Contract Notes (Under Stock Exchange Trading Regulations)*
- (e) *Record of Audit Assignments (as required by ICAI regulations)* (4 × 4 = 16 Marks)

Answer

(a) Categories of Non-banking Finance Companies (NBFCs):

As per Reserve Bank of India Act, 1934, NBFC is one whose principal business is that of receiving deposit or that of a financial institution, such as lending, investment in securities, hire purchase finance or equipment leasing, etc. Categories of such companies are:

- (a) Equipment leasing company engaged in equipment leasing or financing of such activity.
- (b) Hire purchase company engaged in hire purchase transaction or financing of such transaction.
- (c) Investment company engaged in acquisition of securities and trading of securities to earn a profit.
- (d) Loan company engaged in providing finance by making loans and advances, or otherwise for any activity other than its own.
- (e) Residuary non-banking company which receives deposits under scheme or arrangement, by whatever name called, in one lump sum or in installments by way of contributions or subscriptions or by sale of units or other instruments or in any manner.

- (b) **Recognition of Deferred Tax Assets:** Deferred Tax Assets (DTA) are to be recognised as laid down by AS 22 "Accounting for Taxes on Income" a DTA arises on account of a timing difference in which the taxable income is more than the book income. A deferred tax asset (and the corresponding tax saving) should be recognised only after applying the test of prudence. Thus, where the enterprise does not have unabsorbed depreciation and carried forward losses as per the tax laws, deferred tax assets should be recognised and carried forward to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realized. In other words, no deferred tax asset should be created if there is no reasonable certainty about the requisite future taxable income. The existence or absence of a reasonable level of certainty would normally be determined by examining the past record of the enterprise and by making realistic estimates of profits for the future.

A much stricter test of prudence has to be satisfied where the enterprise has unabsorbed depreciation or carried forward losses under tax laws. In such a situation, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realized. The existence of unabsorbed depreciation or carried forward losses under tax laws is strong evidence that future taxable income may not be available. Therefore, in such a situation, the enterprise can recognise deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient taxable income or there is other convincing evidence of virtual certainty of availability of sufficient taxable income against which deferred tax assets can be realized.

ICAI has stated that virtual certainty refers to the extent of certainty which, for all practical purposes, can be considered certain. Determination of virtual certainty of availability of sufficient future taxable income is a matter of judgement which will have to be made on a case-to-case basis.

- (c) **Valuation of Investments "Held to Maturity":**

The banks are required to classify their entire investment portfolio into three categories: held to maturity (HTM), available for sale (AFS), and held for trading (HFT). Securities acquired with the intention to hold them up to maturity should be classified under HTM category. Thus, this category will comprise only debt securities (e.g., debentures, redeemable bonds, government securities), preference shares and similar securities having a defined period of maturity, except that equity shares of subsidiaries/joint ventures have also to be included in HTM category.

- (i) These investments need not be Marked to Market and will be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortized over the period remaining to maturity. For instance if a bond is acquired at say Rs.90 and it is redeemable at Rs.100 after three years, the discount, i.e., Rs.10 should also be amortised as income over the next three years unless there is significant uncertainty of receipt of full face value on maturity.

- (ii) Any diminution, other than temporary should be recognised in the value of their investments in subsidiaries/JVs and provided for. Such diminution should be determined and provided for each investment individually.
- (d) **Contract Notes (Under Stock Exchange Trading Regulations):** Contract note is a document through which a contractual obligation is established between a member and a client. Every member of the stock-exchange has to issue contract notes to his clients for the trades executed on their behalf. The auditor should apply appropriate audit procedure to satisfy himself that:
- ◆ Contract notes have been serially numbered
 - ◆ No serial number has been left blank
 - ◆ Format is as prescribed by the regulations on the exchange
 - ◆ Duplicate copies /counterfoils of contract notes are maintained
 - ◆ Brokerage charged in contract notes is within the permissible limits and is indicated separately including service tax
 - ◆ It is signed by an authorised person
 - ◆ It has been issued in respect of all transactions
 - ◆ Transaction identification trade identification and trade execution time has been printed on the contract note issued
 - ◆ SEBI Registration No., Settlement No., Settlement Dates have been mentioned
 - ◆ PAN No. of the member and client has been mentioned on contract note where if required
 - ◆ All clauses specified by the Exchange have been printed on the reverse of the contract notes.
- (e) **Record of Audit assignments:** In exercise of the powers conferred by clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India issued a notification which specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the “specified number of audit assignments of the companies under Section 224 and /or Section 228 of the Companies Act, 1956. As a part of this notification, to meet its requirements, a CA in practice as well as a firm in practice shall maintain a record of the audit assignments accepted as laid out in notification issued by the Council of the ICAI under Part II of Second Schedule to the Chartered Accountants Act, 1949 in respect of ceiling on audits containing following particulars:
- (i) Name of Company Audit/ Assignment.
 - (ii) Regn. No.
 - (iii) Date of appointment with Registrar of Companies.
 - (iv) Date of acceptance.
 - (v) Date on which form 23B filed.