CA Final: Advanced Auditing, November 2008
Suggested Hints
(All the hints except for Q 1 and Q 5(a) are from the book "Professional Approach to Advanced Auditing" authored by CA Kamal Garg, published by Bharat Law House Private Limited)

Q1 (a)	Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period (para 9). Taxes on income are considered to be an expense incurred by the enterprise in earning income and are accrued in the same period as the revenue and expenses to which they relate. Such matching may result into timing differences. The tax effects of timing differences are included in the tax expense in the statement of profit and loss and as deferred tax assets (subject to the consideration of prudence as set out in paragraphs 15-18) or as deferred tax liabilities, in the balance sheet (para 10). **[See AS 22]**
Q 1 (b)	In certain circumstances, a government grant is awarded for the purpose of giving immediate financial support to an enterprise rather than as an incentive to undertake specific expenditure. Such grants may be confined to an individual enterprise and may not be available to a whole class of enterprises. These circumstances may warrant taking the grant to income in the period in which the enterprise qualifies to receive it, as an extraordinary item if appropriate (Accounting Standard AS – 5, Prior Period and Extraordinary Items and Changes in Accounting Policies). **[See AS 12]**
Q 1 (c)	AS 3 is not mandatory for Small and Medium Sized Companies, as defined in the Notification dated 7-12-2006. Such companies are however encouraged to comply with the Standard. However, that's not the case with AS 18
Q 1 (d)	Costs that are incurred unevenly during an enterprise's financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year (para 38). **[See AS 25]**
Q 2 (a)	See Clause 2 Part IV of First Schedule to the CA Act (as amended). **[Chapter: Code of Ethics]**
Q 2 (b)	See **No. 1-CA (7)/93/2006.** Minimum fees prescribed by ICAI. More than that its based upon Client and Auditor's agreement. **[Chapter: Code of Ethics]**
Q 2 (c)	See Section 6. Editorship of other than professional journals requires specific permission. **[Chapter: Code of Ethics]**
Q 2 (d)	According to the Research Committee of the Institute "a question often arises as to whether indebtedness arises in cases where in accordance with the terms of his engagement by a client (e.g. resolution passed by the general meeting) the auditor recovers his fees on a progressive basis as and when a part of work is done without waiting for the completion of the whole job. In these circumstances, where in accordance with such terms, the auditor recovers his fees on a progressive basis, he cannot be said to be indebted to the company at any stage." **[Chapter: The Company Auditor]**
Q 3 (a)	*Liabilities towards third parties* – if the following essentials are present then he would be liable towards third parties:

	• the untrue statement; • the auditor knew it to be false or he was recklessly and consciously ignorant of the truthfulness; • the statement was made with an intention that the aggrieved person should act on it; and • the aggrieved has actually acted on it and suffered loss. **[Chapter: Liabilities of Auditor]**
Q 3 (b)	Duties of Auditor: (i) whether any of the directors of the company has attracted disqualification should be considered at the balance sheet date; (ii) while reporting on the financial statements of a particular year, the auditor will have to ascertain whether a person appointed as director in the auditee company was not a director of another public company which has defaulted in terms of section 274 (1) (g) during the last five years; (iii) Obtain a written representation from the company as to: • Names of directors of the company during the period covered by the auditor's report (showing separately the names of nominee directors) along with particulars of appointment/reappointment, resignation, retirement, etc., of each of the above directors; • Whether each relevant director has submitted Form DD-A; • Whether the information contained in the register of directors maintained under section 303(1) is updated to show the position as on the balance sheet date; • Whether the company has committed any default under section 274(1) (g). In case the company has committed a default of the aforesaid nature, whether the company has furnished Form DD-B. (iv) the auditor should require the director to submit a written representation that no default has taken place under section 274 (1) (g) as at the balance sheet date; (v) if a company as a matter of practice obtains a legal compliance report, the auditor may examine such report; (vi) if provisions of section 274 (1) (g) have been satisfied by the public company, the auditor must report that all the directors are disqualified from being appointed as director under section 274 (1) (g) **[Chapter: Guidance Note for Reporting u/s 227(3) (e) & (f)]**
Q 4 (a)	(i) whether the directives issued by the Reserve Bank of India and the provisions of sections 58A, 58AA or any other relevant provisions of the Act and the rules framed there under, where applicable, have been complied with. (ii) If not, the nature of contraventions should be stated; (iii) If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal whether the same has been complied with or not **[See Clause 4 (vi) under Chapter: CARO]**
Q 4 (b)	**System of Accounts** 1. Examine the following systems and give your views as regards their deficiencies

<table>
<tr><td></td><td>along with suggestions for remedial measures:
(a) Recording of receipts and expenditure.
(b) Drawing periodical trial balance.
(c) Compilation of accounts.
(d) Reconciliation of inter-office accounts.
(e) Reconciliation of registers /records relating to property, assets, investments, premiums, claims, loans, etc., with financial books.
(f) Maintenance of up-to-date records in respect of assets, which are pledged, encumbered or blocked in any way.
2. Are the bank accounts of the company reconciled with the bank statements regularly? If not, describe the failures.
3. Are control accounts and subsidiary accounts up-to-date and reconciled regularly? If not, describe the failures.
4. Examine the accounting policies of the company. Are these in conformity with the Accounting Standards (National and in the absence of National Standards, the corresponding International Standard)? Give particulars of material departures from these standards, if any, along with their effect on the financial statements; quantify the impact wherever possible. [Appendix 1: Chapter: Audit of General Insurance Companies]</td></tr>
<tr><td>Q 5 (a)</td><td>“Small and Medium Sized Company” (SMC) means, a company-
• whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;
• which is not a bank, financial institution or an insurance company;
• whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;
• which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and
• which is not a holding or subsidiary company of a company which is not a small and medium-sized company.
Hence,
1. If the foreign company is required to prepare its financial statements as per Company AS Rules, then the Indian company needs to follow because it is Non-SMC enterprise;
2. SMC;
3. Non-SMC</td></tr>
<tr><td>Q 5 (b)</td><td>Financial Indications:
• Negative net worth or negative working capital;
• Excessive reliance on short term borrowings to finance long term assets;
• Adverse key financial ratios;
• Substantial operating losses or negative cash flows from operations;</td></tr>
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	• Inability to pay creditors on due dates; • Difficulty in complying with the terms of loan agreements; • Change from credit to cash-on-delivery transactions with suppliers; • Entering into a scheme of arrangement with creditors for reduction of liability. **[See AAS 16, Chapter: Auditing and Assurance Standards]**
Q 6 (a)	(a) Investments are classified into 'held-to-maturity', 'available-for-sale' and 'held-for-trading' investments, in accordance with the guidelines issued by RBI. (b) 'Held-to-maturity' category comprises securities acquired by the bank with the intention to hold them up to maturity. 'Held-for-trading' category comprises securities acquired by the bank with the intention of trading, i.e. to benefit from short term price/ interest rate movements. 'Available-for-sale' securities are those which do not qualify for being classified in either of the above categories, i e., those which are acquired neither for trading purposes nor for being held till maturity. (c) Investments classified as held-to-maturity category are carried at acquisition cost unless it is more than the face value, in which case the premium is amortised over the period remaining to maturity. Any diminution in the value of investments in under held-to-maturity category is provided for if such diminution is other than temporary in nature. Such diminution is determined and provided for each investment individually. (d) The individual scrips in the available-for-sale-category are marked to market. The net depreciation under each of the six classifications (viz., Central and State Government and other approved securities, shares, etc.) under which investments are presented in the balance sheet is fully provided for, whereas the net appreciation under any of the aforesaid classifications above is ignored. (e) The individual scrips in the held-for-trading category are marked to market and the net appreciation/ depreciation of scrips depreciation under each of the six classifications under which investments are presented in the balance sheet is recognised in the P & L a/c. (f) The depreciation in value of securities where interest/ principal is in arrears is not set off against the appreciation in respect of other performing securities. (g) Profit or loss on sale of investments in any category is taken to the P & L a/c. In case of profit on sale of investments in held-to-maturity category, an equivalent amount is appropriated to the `Capital Reserve A/c'. **[Chapter: Audit of Banks]**
Q 6 (b)	See (i) Clause 17 and (ii) Clause 27 of Form 3CD **[Chapter: Tax Audit]**
Q 7 (a)	The following aspects are to be considered in respect of various industrial units while conducting an environmental audit: (i) Layout and design; (ii) Management of resources; (iii) Pollution control systems; (iv) Emergent safety system; (v) Medical and healthcare facilities; (vi) Industrial hygiene; (vii) Occupational health;

	(viii) Information assimilation and reporting system; (ix) EIA methodology (x) Compliance to the Regulatory mechanism; (xi) Concern for the society. **[Chapter: Special Aspects]**
Q 7 (b)	Drafting has to be made on the guidelines given by AAS 26
Q 8 (a)	**Investor Education and Protection Fund (Section 205C):** The Central Government shall establish a fund to be called the Investor Education and Protection Fund (hereafter in this section referred to as the "Fund"). There shall be credited to the Fund the following amounts, namely: (a) amounts in the unpaid dividend accounts of companies; (b) the application moneys received by companies for allotment of any securities and due for refund; (c) matured deposits with companies; (d) matured debentures with companies; (e) the interest accrued on the amounts referred to in clauses (a) to (d); (f) grants and donations given to the Fund by the Central Government, State Governments, companies or any other institutions for the purposes of the Fund; and (g) the interest or other income received out of the investments made from the Fund: The Fund shall be utilised for promotion of investor awareness and protection of the interests of investors in accordance with such rules as may be prescribed.
Q 8 (b)	In case of contingent liabilities the Auditor should generally follow the audit procedure given below: (i) Examine the system of authorisation and internal controls relevant to contracts giving rise to Contingent Liabilities; (ii) Ascertain the maintenance of adequate records; (iii) Perform substantive test to establish completeness of recorded obligation; (iv) Obtain representation from the management that all the Contingent liabilities have been identified, quantified and do not include items likely to result in a loss. The procedure to verify the various elements of contingent liabilities is as follows: *Claims against the bank not acknowledged as debt* (i) Examine external evidences like correspondences with Lawyers, claimants etc.; (ii) Review the minutes of board meetings; (iii) Obtain representation from the management about the status of such claims;

	(iv) Review the subsequent events. *Liability on Partly paid Shares* (i) Examination of Certificates of investment is the best procedure to ascertain such liabilities; *Liability on outstanding Forward Exchange Contracts* (i) The auditors may verify these liabilities with the registers maintained and copies of broker's notes. *Guarantees given on behalf of Constituents* (i) The auditor should ascertain adequacy of internal control over issuance of guarantees, e.g., whether guarantees are issued under proper sanction, whether margins are taken from customers etc.; (ii) The auditor should ensure that unused guarantee forms are in proper custody; (iii) Substantive test of guarantees given may be performed through the guarantee register. *Acceptances, Endorsements and other Obligations* These include letters of credit issued arid bills discounted or purchased by the bank. The audit procedure should involve evaluation of internal control system and verification of the relevant registers and copies of letter of credit issued. **[Chapter: Audit of Banks]**
Q 8 (c)	As per Para 3, the following terms are used in this Statement with the meanings specified: ***Borrowing costs*:** Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds. However as Para 4 of this Statement, borrowing costs may include: (a) interest and commitment charges on bank borrowings and other short-term and long-term borrowings; (b) amortisation of discounts or premiums relating to borrowings; (c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings; (d) finance charges in respect of assets acquired under finance leases or under other similar arrangements; and (e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. ***Qualifying asset*:** A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. **[See AS 16]**
Q 8 (d)	Permanent consolidation adjustments are those adjustments that are made only on the first occasion of the preparation and presentation of consolidated financial statements. Permanent consolidation adjustments are: (a) determination of excess or deficit of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made (determination of goodwill or

	capital reserve); (b) determination of the amount of equity attributable to minorities at the date on which investment in subsidiary is made; and (c) determination of goodwill or capital reserve arising on application of equity method to account for investments in associates in consolidated financial statements. **[See Guidance Note on Audit of Consolidated Financial Statements]**
Q 8 (e)	A reinsurance transaction may be defined as an agreement between a 'ceding company' and a 'reinsurer' whereby the former agrees to 'cede' and the latter agrees to accept a certain specified share of risk or liability as per the terms set out in the agreement. It may be noted that the insured does not acquire any right under a reinsurance contract. In the event of loss, the insured's claim for full amount is against the original insurer only. The original insurer, in turn, lodges a claim with the reinsurer. *Facultative Reinsurance:* Reinsurance whereby separate contracts are entered into for each particular risk. This type of reinsurance is used either when risks are not covered under treaties or the issuer does not want to cover the risk under the treaty etc. **Chapter: Audit of General Insurance Companies]**
Q 8(f)	See AAS 6 **[Chapter: Auditing and Assurance Standards]**