

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

QUESTIONS

1. Briefly explain how an auditor can use the work of an expert.
2. (a) What is meant by "Representations by Management" and indicate to what extent an auditor can place reliance on such representations ?
(b) An old car of a company having a nominal book value has found a buyer, who is willing to pay Rs. 1 lakh for it. The company proposes not to sell the car, but to neglect its valuation in its accounts at Rs. 1 lakh. Should the auditor permit the company to do so?
3. As a statutory auditor for the year ended 31st March 2008, how would you deal with the following?
 - (a) As on 31/3/2007, the equity share capital of Lini Ltd. is 10 crores divided into shares of Rs.10 each. During the financial year 2007/08, it has issued bonus shares in the ratio of 1:1. The net profit after tax for the years 31/3/2007 and 31/3/2008 is Rs.8.50 crores and Rs.11.50 crores respectively. The Earnings per Share (EPS) disclosed in the accounts for two years is Rs.8.50 and Rs.5.75 respectively.
 - (b) Simon Ltd., a listed company, was incurring heavy losses since the last several years and the industry in which it was functioning was not expected to perform better in the next few years. While finalising the accounts for the year ended 31st March 2008, the CFO of the company decided to create 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.
 - (c) Reena Ltd., has borrowed Rs.25 crores from financial institutions during the financial year 2007/08. These borrowings are used to invest in shares of Ajit Ltd., a subsidiary company which is implementing a new project estimated to cost Rs.50 crores. As on 31st March 2008, since the said project was not yet complete, the directors of Reena Ltd. resolved to capitalize the interest on the borrowings amounting to Rs.3 crores and add it to the cost of investments.
 - (d) "There should be sufficient liaison between a principal auditor and other auditors". Discuss the above statement and state in this context the reporting considerations, when the auditor uses the work performed by other auditor.
4. State your views as an auditor on the following:
 - (a) During the year under audit Zeenath Ltd. credited to the Profit and Loss Account, the entire profit of Rs.20 lakhs on the sale of land not required for its use. You are informed that the directors would like to propose dividend out of the above profit.

- (b) Venkate Ltd. had announced a voluntary retirement plan for its employees on January 1, 2008. The scheme is scheduled to close on June 30, 2008. The scheme envisaged an initial lump sum payment of maximum of Rs. 2 lakhs and monthly payments over the balance period of service of employees coming under the plan. 200 employees opted for the scheme as on March 31, 2008. The total lump sum payment for these employees would be Rs. 250 lakhs and the aggregate of future payments to them would amount to Rs.1,500 lakhs. However, no payment had been made to the employees under the scheme up to March 31, 2008. Nor the company made any provision in its accounts towards any liability under the scheme.
5. As a statutory auditor of a Public Limited Company, how would you deal with the following situations?
- (a) The company had subscribed to shares of associate companies amounting to Rs.5 crores. These associate companies have incurred substantial losses and have been referred to BIFR for being declared as sick companies. The company does not want to make any provision for the fall in the value of the investments.
- (b) As at the beginning of the year, the company has a capital of Rs.2.50 crores, free reserves of Rs.0.50 crores and Revaluation Reserve of Rs.4.50 crores. In the relevant year under audit the company has incurred a loss of Rs.4 crores. The company proposes to adjust the loss with the Revaluation Reserve.
6. Write short notes on the following:
- (a) Evaluating inherent risk
- (b) Evaluating internal control
7. Answer the following:
- (a) Mention the difference between 'report' and 'certificate.'
- (b) What are the contents of reports and certificates for special purposes?
- (c) What are the reporting requirements for closing stocks in the Manufacturing and other Companies (Auditors Report) Order, 1988?
8. (a) Distinguish with suitable examples - Between a case where an auditor is obliged to state in his report to the members of a company that the accounts do not show a true and fair view, and a case where he states that he is unable to form an opinion as to whether or not the accounts give a true and fair view.
- (b) Write short note on - Reporting on the compilation engagement
9. (a) Describe the procedure for verification of the following balances appearing in the account books of a bank:
- (i) Drafts paid without advice
- (ii) Branch adjustment account

- (b) As a branch auditor of a nationalised bank, how would you verify the following?
 - (i) Advances to DOT COM Companies.
 - (ii) Balances in account of a bank situated in a foreign country.
- 10. Answer the following:
 - (a) Describe the audit procedures to be followed for verification of premiums by a statutory auditor of a general insurance company.
 - (b) Enumerate the steps to be taken by an auditor for the verification of Re-insurance outward by a General Insurance Company.
- 11. Answer the following:
 - (a) What is meant by True and Fair Cost of Production?
 - (b) Reconciliation of cost and financial accounts
 - (c) Write short note on - Advantages of Cost Audit to Government
- 12. Comment on the following :

An American Company engaged in the business of manufacturing and distribution of industrial gases, is interested in acquiring a listed Indian Company having a market share of more than 65% of the industrial gas business in India, request you to conduct a "Due Diligence" of this Indian Company and submit your Report. As due Diligence Auditor, what key areas you will cover in your review? List out the contents of your Due Diligence Review Report that you will submit to your USA based Client.
- 13. (a) What are the Management Audit Questionnaires? Give a sample questionnaire for Audit of Inventory.
- (b) "Operational auditing is not different from internal auditing." Discuss.
- 14. (a) Briefly discuss the compliance procedures and their use in evaluation of internal controls.
- (b) Write short explanatory note on - Flow chart technique for evaluation of internal control.
- 15. As a practising chartered accountant do you approve the following? If not, why?
 - (a) In a representation to be submitted to a company under section 225(3) of the Companies Act, 1956, the partner of the firm of auditors wants to include the contributions made by the firm in strengthening the control procedures of the company during their association with the company.
 - (b) A partner of a firm of chartered accountants during a T.V. interview handed over a bio-data of his firm to the chairperson. Such bio-data detailed the standing of the international firm with which the firm was associated. It also detailed the achievements of the concerned partner and his recognition as an expert in the field

of taxation in the country. The chairperson read out the said bio-data during the interview.

- (c) The Chairman of an Audit Committee of a Bluechip Company, who is a chartered accountant asked the firm in which he was previously a partner to quote their fee on a success fee basis so as to ensure that a professional work is assigned to such firm.
 - (d) A firm of chartered accountants were appointed by a company to evaluate the costs of the various products manufactured by it for their information system. One of the partners of the firm of chartered accountants was a non-executive director of the company.
16. Your firm has been appointed as Central Statutory Auditors of a Nationalised Bank. The Bank follows financial year as accounting year. State your views on the following issues which were brought to your notice by your Audit Manager:
- (a) In computing the aggregate of funded and non-funded exposure of a constituent for purpose of assigning risk weight in regard to capital adequacy, the bank "Netted off" the credit balance of Rs.10 lakhs in their Current Account against the total exposure of Rs.1 crore.
 - (b) The bank has recognised on accrual basis income from dividends on securities and Units of Mutual Funds held by it as at the end of financial year. The dividends on securities and Units of Mutual Funds were declared after the end of financial year.
 - (c) The bank is a consortium member of Cash Credit Facilities of Rs.50 crores to X Ltd. Bank's own share is Rs.10 crores only. During the last two quarters against a debit of Rs.1.75 crores towards interest the credits in X Ltd's account are to the tune of Rs.1.25 crores only. Based on the certificate of lead bank, the bank has classified the account of X Ltd as performing.
 - (d) In case of all such advances which have been classified as non-performing for the first time during the current financial year, only the last date of the financial year has been reckoned as the date of account becoming non-performing.
17. (a) A public charitable trust earns 'income' of Rs.10 lakhs from Unit Trust of India, which is not taxable under Section 10(33) of Income-tax Act, 1961. It spends Rs.7 lakhs on its activities. The entire expenditure is vouched and is in accordance with the trust objects and is fully allowable as 'application'. As Auditor of the Trust, would you require the trust to make any provision for tax in its accounts?
- (b) Mr. X, who conducts the tax audit u/s 44AB of the Income-tax Act, 1961 of M/s ABC, a partnership firm has received the entire audit fees of Rs.25,000 in April, 2008 in respect of the tax audit for the year ended 31.3.2008. The audit report was however signed in September, 2008.
 - (c) Mr. P carries on the business of dealing and export of diamonds. For the year ended 31st March, 2008, you as the tax auditor, find that the entire exports are to another firm in U.S.A., which is owned by Mr. P's brother.

18. Write short note on the following -
- (a) Hit or take orders
 - (b) Contract notes
 - (c) Rolling Settlement
 - (d) Sauda Book
19. Explain the Auditor's liability in case of unlawful acts or defaults by clients.

SUGGESTED ANSWERS/HINTS

1. Expert: AAS-9 (SA 620) on, "Using the Work of an Expert" discusses the auditor's responsibility in relation to, and the procedures the auditor should consider in, using the work of an expert as audit evidence. The auditor has to first determine the need to use the work of an expert considering the materiality of the item, its nature and complexity. It would be necessary in cases of valuation of certain types of assets, determining the physical condition of the assets like minerals, actuarial valuation of gratuity, determining work in progress in case of construction contracts, etc. Generally, the auditor's education and experience enable him to be knowledgeable about business matters in general, but he is not expected to have the expertise of a person trained for, or qualified to engage in, the practice of another profession or occupation, such as an actuary or engineer.

When the auditor plans to use the expert's work as audit evidence, the auditor is required to assess skill and competence of the expert, his objectivity and, finally, evaluate the work done by him. So first of all, the auditor should satisfy himself as to the expert's skills and competence by considering the expert's:

- ◆ professional qualifications, license or membership in an appropriate professional body, and
- ◆ experience and reputation in the field in which the evidence is sought.

However, when the auditor uses the work of an expert employed by him, he will not need to inquire into his skills and competence. The auditor should also consider the objectivity of the expert. Finally, when the auditor intends to use the work of an expert, he should examine evidence to gain knowledge regarding the terms of the expert's engagement and such other matters as:

- ◆ the objectives and scope of the expert's work,
- ◆ a general outline as to the specific items in the expert's report,
- ◆ confidentiality of the expert's work, including the possibility of its communication to third parties.
- ◆ the expert's relationship with the client, if any,
- ◆ confidentiality of the client's information used by the expert.

The auditor should seek reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial information, by considering:

- ◆ the source data used,
- ◆ the assumptions and methods used and, if appropriate, their consistency with the prior period,
- ◆ the results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of his audit procedures, and
- ◆ the auditor should also satisfy himself that the substance of the expert's findings is properly reflected in the financial information.

The auditor should consider whether the expert has used source data which are appropriate in the circumstances. The procedures to be applied by the auditor should include :

- ◆ making inquiries of the expert to determine how he has satisfied himself that the source data are sufficient, relevant and reliable, and
- ◆ conducting audit procedures on the data provided by the client to the expert to obtain reasonable assurance that the data are appropriate.

The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. The auditor does not have the same expertise and, therefore, cannot always challenge the expert's assumptions and methods. However, the auditor should obtain an understanding of those assumptions and methods to determine that they are reasonable based on the auditor's knowledge of the client's business and on the results of his audit procedures.

If after performing all these procedures the auditor concludes that the work of the expert is not consistent with the information in the financial statements or that it does not constitute sufficient appropriate audit evidence, the auditor should express a qualified, disclaimer or an adverse opinion. In other cases, the opinion has to be unqualified. If while giving his report the auditor considers it appropriate to disclose the identity of the expert, he should obtain his prior consent.

2. (a) The management is responsible for the appropriate preparation and presentation of financial information. Thus it is quite natural that during the course of audit, management would be required to make several representations on various matters relating to financial statements. These representations may be made by the management either in orally or in writing to the auditor. For example, the auditor may ask the management to confirm about the existence of contingent liabilities and disclosure thereof, etc. In other words, representation by management constitutes acknowledgement by the management about its responsibility for the preparation and approval of the financial information. A written representation may either take the form of a letter from the management or letter by auditor outlining auditor's understanding and confirmation of the same.

Extent of Reliance: AAS-11 (SA 580), "Representations by Management", states that management representations whether obtained orally or in writing institute audit evidence and establishes standards for evaluating the same. AAS-11 (SA 580) requires that the auditor may rely upon the management's representation, preferably in writing, as a sort of information or evidence to consider and if the representations relate to matters which are material to financial information, Further, the auditor should:

- (a) seek corroborative evidence from sources inside or outside the entity.
- (b) evaluate whether the representations made by the management appear reasonable and consistent with other audit evidence obtained, including other representations; and
- (c) consider whether the individuals making the representations are expected to be well informed on the matter.

However, it must be note that representations by the management cannot be the substitute for other audit evidence that the auditor could reasonably expected to be available. For example, a representation by the management as to existence, quantity and cost of inventories is not substitute for adopting audit procedures regarding verification and valuation of inventories. If a representation by management is contradicted by other evidence, the auditor should examine the circumstances and, when necessary, reconsider the reliability of other representations made by the management as well.

- (b) The old car formed part of the fixed assets of the company and ordinarily the same should be valued at actual cost less depreciation written off. The market price of any of such assets is not relevant for balance sheet valuation of a going concern. However, there is no prohibition in law for revaluation of fixed assets. The accounting principle also allows revaluation, to reflect the fixed assets at their replacement cost. But when all other assets are presumably shown at historical cost, revaluation only of one motorcar seems illogical and has the effect of distorting the overall view of the accounts. Further, revaluation should be carried out on the basis of proper appraisal, normally undertaken by competent valuers. AS- 10, "Accounting for Fixed Assets" also clarifies that selective revaluation of assets can lead to unrepresentative amounts being reported in financial statements. Accordingly, when revaluations do not cover all the assets of a given class, it is appropriate that the selection of assets to be revalued be made on a systematic basis. For example, an enterprise may revalue a whole class of assets within a unit. Thus, as per AS 10, when a fixed asset is revalued in financial statements, an entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis. This basis should be disclosed. In the present case, there is no proper appraisal and a revaluation based on one stray bid is not proper to establish a proper replacement value of an antiquated item of asset. The

willingness of a buyer to pay the particular price is not logical basis to work out the value of the asset. Because, by this process it may happen that the net book value of the assets might be greater than the recoverable amount of the asset. Therefore, the company though proposes not to sell the car at Rs. One lakh yet it has decided to neglect its value in the accounts. In view of the fact that the company has been taking proper step, the auditor should permit the company to neglect the valuation of car in the accounts because it is in accordance with the relevant requirements of the accounting standards.

3. (a) Disclosure of Earnings Per Share: AS-20 on Earnings Per Share (EPS) prescribes principles for the determination and presentation of earnings per share. 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, 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 the Standard, in the case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration. 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 have 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. The standard also explains how the earnings per share is to be calculated in the case of a bonus issue of shares.

In view of the above, the earnings per share for both the years will have to be calculated taking the equity share capital after the bonus issue as the denominator. If the same is done the earnings per share for 31/3/2007 will be Rs.4.25 and that for 31/3/2008 will be Rs.5.75. Since the above figures of earnings per share have not been disclosed, the company has not complied with the provisions of the standard. If the same is not followed, he would then have to qualify his report in terms of Section 227 (3) (d) of the Companies Act, 1956.

- (b) Recognition of Deferred Tax Assets: Accounting Standard 22 on "Accounting for Taxes on Income", requires that deferred tax should be recognised for all timing differences, subject to the considerations of prudence in respect of deferred tax assets. The standard further states that where an enterprise has unabsorbed depreciation or carry forward of losses under the tax laws, 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 realised. In this context, virtual certainty supported by convincing evidence would mean that there is a reasonable certainty that the carry forward losses would be recouped in the future years. In the instant case, looking to the fact that the industry in which the company was functioning was

not expected to perform well in the next few years, getting virtual certainty and convincing evidence for the same would be almost impossible. Hence, in the absence of virtual certainty for offset of the losses in future years, creating a deferred tax asset would not be possible for the company. The statutory auditor would therefore have to qualify his report by stating that deferred tax assets have been created though there is no virtual certainty for getting the said benefit in income tax. He would also have to mention the amount by which the loss for the year has been understated and the amount by which the reserves are overstated.

- (c) Capitalisation of Interest on Borrowings in respect of Investments: As per Accounting Standard 13 on "Accounting for Investments", the cost of investment includes acquisition charges such as brokerage, fees and duties. In the instant case, Reena Ltd. has used borrowed funds for making investment in shares of a subsidiary company. For acquiring shares of a subsidiary company, apart from any fees, duties etc., there are no cost incurred for investing in shares. Hence, any borrowing costs incurred cannot be treated as part of cost of investments and cannot be added to the cost of investments. The Accounting Standard 16 on "Borrowing Costs" also does not consider investment in shares as qualifying assets that can enable a company to add the borrowing costs to investments. In the instant case therefore, 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 the profit and loss account. The effect of the same on the profit for the year would also have to be mentioned in the audit report.
- (d) AAS-10 (SA 600) on "Using the work of another auditor" lays down the procedure to be applied in situations where a principal auditor reporting on the financial statement of the entity uses the work of another independent auditor. AAS- 10 (SA 600) contemplates coordination between auditors and requires that there should be sufficient liaison between the principal auditor and the other auditor. For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

The other auditor, knowing the context in which his work is to be used by the principal auditor, should coordinate with the principal auditor. For example, by bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements. Similarly, the principal auditor should advice the other auditor on any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

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

The reporting considerations laid down by AAS are as under:

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

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

4. (a) Profit of Rs. 20 lakhs on the sale of land is a capital profit. It represents the excess of sale value over the original cost of the asset. The question whether such a profit can be distributed as dividend has been considered in two legal cases, viz., *Lubbock vs The British Bank of South America Ltd.* and *Foster vs The New Trinidad Lake Aspha/te Co. Ltd.* Based on the Court judgements, it is argued that capital profits can be distributed by a company only if all the following conditions are fulfilled:

- (i) The articles of association should permit distribution of capital profits.
- (ii) The capital profit which is sought to be distributed should have actually been realised.

Unrealised capital profits, e.g., those arising on a revaluation of fixed assets, cannot be distributed as dividends. However, if the assets so revalued are subsequently sold, the amount realised over and above the original cost of such assets is a capital profit available for distribution as dividend (provided the other conditions are satisfied).

- (iii) The capital profit should remain after a proper valuation has been fairly taken of the whole of the assets and liabilities. In other words, any fall or deficiency in the value of other assets or appreciation in the amount of liabilities should be deducted from the amount of capital profits to ascertain the amount which can properly be regarded as distributable as dividend.

However, Accounting Standard 10 on "Accounting for Fixed Assets" requires that any gain arising from disposal of a fixed asset should be recognised in the profit and loss account. Moreover, section 205 of the Companies Act, 1956 does not make any distinction between capital profit and other profit. Thus, all profits which can properly be taken to the profit and loss account are 'profits' for the purposes of section 205 and are, thus, distributable.

- (b) Accounting Standard (AS)- 4 (Revised) on 'Contingencies and Events Occurring After the Balance Sheet Date', states that events occurring after the 'balance sheet

date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity.

Two types of events can be identified as:

- (a) those which provide further evidence of conditions that existed at the balance sheet date; and
- (b) those which are indicative (of conditions that arose subsequent to the balance sheet date).

It further states that assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.

As per facts of the case, a condition existed on the balance sheet date (31st March, 2008) regarding the liability towards the Voluntary Retirement Plan (VRP) since the management started the VRP in the month of January, 2008 and 200 employees opted for the VRP as on March 31, 2008. Since it was probable that future events will confirm that a liability has been incurred on the balance sheet date and that the amount could be estimated on reasonable basis, a provision for payments under the VRP would be required to be made for an appropriate amount for the aforesaid number of employees.

5. (a) Valuation of Investments: AS 13 on "Accounting for Investments" requires investments to be classified as long term and current investments distinctly in its financial statements. The investments in shares of associate companies can very well be considered as trade investments since they would not be intended to be liquidated within a period of one year from its acquisition. Hence they would be classified as long term investments.

AS 13 states, "long-term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually". In the instant case, these associate companies have incurred substantial losses and have been referred to BIFR for being declared as sick companies. The net worth of these companies would have been wiped out resulting in a fall in the value of the investments. Therefore, such fall cannot be merely temporary as the companies could take a long time to turn around (if at all) and again have a positive net worth. The auditor would therefore have to qualify his report by saying that no provision for diminution for fall in the value of investments as required by AS 13 has been made and to that extent the profits and reserves have been overstated.

- (b) Adjustment of Loss against Revaluation Reserve: AS-10 on "Accounting for Fixed Assets" states that an increase in net book value of fixed assets is normally credited to owner's interest and under the heading Revaluation Reserves except that, to the extent that such increase is related to and not greater than a decrease arising on revaluation previously recorded as a charge to the profit and loss statement, it may be credited to the profit and loss statement. A decrease in net book value arising on revaluation of fixed asset should be charged directly to the profit and loss statement except that to the extent that such a decrease is related to an increase which was previously recorded as, credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to that account. The Guidance Note on Treatment of Reserve created on Revaluation of Fixed Assets states that where the value of fixed assets is written up in the books of account of a company, the corresponding credit appearing as revaluation reserve does not represent a realised gain and is, therefore, not available for distribution as dividend. Similarly, accumulated losses and the depreciation on the acquisition cost (including arrears of depreciation) should not be adjusted against revaluation reserve since this would amount to setting off actual losses against unrealised gains.

The auditor should explain to the management that accumulated losses cannot be adjusted against the revaluation reserve created on revaluation of the fixed assets. In case the company in question does so, the balance sheet of the company will not reflect a true and fair view of the state of affairs of the company keeping in view the magnitude of the amounts involved, i.e., accumulated losses amount to Rs.4 crores and share capital and reserves amount to Rs.3 crores (excluding revaluation reserve). If the management does not agree with the opinion of the auditor, the auditor may even issue an adverse report.

6. (a) Evaluating Inherent Risk - To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors, having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment. Examples of are such factors are:

At the Level of Financial Statements:

- ◆ Management's experience and knowledge and changes in management during the period, for example, the inexperience of management may affect the preparation of the financial statements of the entity.
- ◆ Unusual pressures on management, for example, circumstances that might predispose management to misstate the financial statements, such as the industry experiencing a large number of business failures or an entity that lacks sufficient capital to continue operations.

- ◆ The nature of the entity's business, for example, the potential for technological obsolescence of its products and services, the complexity of its capital structure, the significance of related parties and the number of locations and geographical spread of its production facilities.
- ◆ Factors affecting the industry in which the entity operates, for example, economic and competitive conditions as indicated by financial trends and ratios, and changes in technology, consumer demand and accounting practices common to the industry.

At the level of Account Balance and Class of Transactions:

- ◆ Quality of the accounting system.
 - ◆ Financial statements are likely to be susceptible to misstatement, for example, accounts which required adjustment in the prior period or which involve a high degree of estimation.
 - ◆ The complexity of underlying transactions and other events which might require using the work of an expert.
 - ◆ The degree of judgement involved in determining account balances.
 - ◆ Susceptibility of assets to loss or misappropriation, for example, assets which are highly desirable and movable such as cash.
 - ◆ The completion of unusual and complex transactions, particularly at or near period end.
 - ◆ Transactions not subjected to ordinary processing.
- (b) Evaluating Internal Control - The auditors' assessment of the control environment is crucial to the decision on whether to make an extended assessment of controls. This is because a good control environment is conducive to the maintenance of a reliable system of accounting and control procedures. For strategy purposes the auditor should obtain a sufficient understanding of the control environment. The auditor needs an understanding of the accounting systems, regardless of whether the audit strategy will involve an extended assessment of internal accounting controls. This should be done by:
- (a) documenting the extent to which the system is computerised; and
 - (b) preparing or updating overview flowcharts to record the files and transactions relating to significant systems-derived account balances.

If there are significant computer systems, the auditor should obtain an understanding of the IT controls so decide whether to make an extended assessment of monitoring controls. Whether it is necessary to carry out any preliminary work for strategy purposes to ascertain whether IT controls are likely to be satisfactory will depend on the auditor's previous knowledge about IT controls. For an existing audit, the objective will normally be to carry out the minimum work

necessary to update this previous understanding. If more information is needed, or if the engagement is new or substantially changed, the auditor should carry out an overview assessment of IT controls. However, even if auditor has not carried out an overview assessment of the IT controls for strategy purposes, it may be necessary to do so later, to help design and perform substantive tests and draw conclusions on whether proper accounting records have been kept. Whether this work is done before determining the strategy or subsequently as part of the fieldwork is a matter of audit efficiency.

7. (a) **Difference Between Report and Certificate:** A certificate is written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. 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. These words are fundamentally distinct from each other. Etymologically, the word 'certificate' is derived from Latin words certus (Certain) and facere (to make). So, the certificate connotes verification of certain and exact facts. However, the rendition of this type of statement is an impossible task and the auditor's duty indeed becomes onerous. The dictionary meaning of the word 'report' refers to formal account of results after an enquiry, examination or review given by an authorised person or group of reasons.

In other words, when a certificate is issued, the auditor is responsible for the factual accuracy of what is contained therein. However, when a report is given, the auditor 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) **Contents of Reports and Certificates for Special Purposes:** The contents of reports and certificates for special purposes in many cases are specified by statute and cannot be changed. However, in cases where no format has been specified, the reporting auditor can choose the form and contents. In such cases, where a reporting auditor is free to draft his report or certificate, he should consider the following:
- (i) Specific elements, accounts or items covered by the report or certificate should be clearly identified and indicated.
 - (ii) The report or certificate should indicate the manner in which the audit was conducted, e.g., by the application of generally accepted auditing practices, or any other specific tests.
 - (iii) If the report or certificate is subject to any limitations in scope, such limitations should be clearly mentioned.
 - (iv) Assumptions on which the special purpose statement is based should be clearly indicated if they are fundamental to the appreciation of the statement.

- (v) Reference to the information and explanations obtained should be included in the report or certificate. In certain cases apart from a general reference to information and explanations obtained, a reporting auditor may also find it necessary to refer in his report or certificate to specific information or explanations on which he has relied.
- (vi) The title of the report or certificate should clearly indicate its nature, i.e., whether it is a report or a certificate. Similarly, the language should be unambiguous, i.e., it should clearly bring out whether the reporting auditor is expressing an opinion (as in the case of a report) or whether he is only confirming the accuracy of certain facts (as in the case of a certificate). For this, the choice of appropriate words and phrases is important.
- (vii) If the special purpose statement is based on general purpose financial statements, the report or certificate should contain a reference to such statements. However, the report or certificate should not contain a reference to any other statement unless the same is attached therewith. It should be clearly indicated whether or not the statutory audit of the general purpose financial statements has been completed and also, whether such audit has been conducted by the reporting auditor or by another auditor. In case the general purpose financial statements have been audited by another auditor, the reporting auditor should specify the extent to which he has relied on them. He may communicate with the statutory auditor for securing his cooperation and in appropriate circumstances, discuss relevant matters with him, if possible.
- (viii) Where a report requires the interpretation of a statute, the reporting auditor should clearly indicate the fact that he is merely expressing his opinion in the matter. He should take sufficient care to ensure that in respect of matters which are capable of more than one interpretation, his report is not misconstrued as representing a settled legal position.
- (ix) An audit report or certificate should ordinarily be a self-contained document. It should not confine itself to a mere reference to another report or certificate issued by the reporting auditor but should include all relevant information contained in such report or certificate.
- (x) The reporting auditor should clearly indicate in his report or certificate, the extent of responsibility which he assumes. Where the statement on which he is required to give his report or certificate, includes some information which has not been audited, he should clearly indicate in his report or certificate the particulars of such information.

In certain cases, the form and/or contents of the report or certificate, as prescribed by a statute or a notification, may not be appropriate or adequate. In such

situations, the reporting auditor may consider modifying the report or certificate on the basis of the aforesaid parameters, to the extent applicable. In case this is not possible, he should clearly indicate the limitations in his report or certificate itself.

- (c) Reporting Requirements for Closing Stocks Under MAOCARO, 1988: The auditor has to make four specific statements on verification and valuation of closing stocks under MAOCARO, 1988 issued under Section 227(4A) of the Companies Act, 1956. The Order requires the auditor to state “whether physical verification has been conducted by the management at reasonable intervals in respect of finished goods, stores, spare parts and raw materials”. Secondly, the auditor has to state, “Are the procedures of physical verification of stocks followed by the management reasonable and adequate in relation to the size of the company and the nature of its business? If not, the inadequacies in such procedures should be reported”. Further, “whether any material discrepancies have been noticed on such verification as compared to book records, and if so, whether the same have been properly, dealt with in the books of account”. Finally, “whether the auditor is satisfied on the basis of his examination of stocks that such valuation is fair and proper in accordance with the normally accepted accounting principles. Is the basis of valuation of stocks same as in the preceding year? If there is any deviation in the basis of valuation, the effect of such deviation, if material, should be reported”.

The comment on the reasonableness and adequacy of the stock verification procedures requires that the auditor should examine the methods and procedures of such verification and may, if considered appropriate by him, be also present at the time of stock-taking. He should, in any case, examine the instructions given by the management to the stock-taking personnel (which should preferably be in writing). Where stocks are material and the auditor is placing reliance on the physical verification by the management, it may be appropriate for the auditor to attend stocktaking and perform test counts. He should ascertain whether the cut-off procedures are adequate. The original physical verification sheets should be reviewed and selected items traced into final inventories, which in turn should be compared with stock records and other evidence such as stock statements submitted to banks. The procedures for identifying damaged and obsolete items of inventory should be reviewed. While commenting on this clause, the auditor should point out the specific areas where the procedures are not reasonable or adequate.

The auditor should look carefully into all material discrepancies between the book stocks and physical and physical inventories to examine whether the same have been properly adjusted in the books of account.

The auditor has also state whether the valuation of stocks is fair and proper in accordance with the normally accepted accounting principles. To determine what constitute the normally accepted accounting principles regarding valuation of stock, one may refer to Accounting Standard 2. This standard provides that, in general, inventories should be valued at the lower of historical cost and net realisable value.

8. (a) AAS 1 (SA 200) " Basic Principles Governing an Audit" states that the audit report should contain a clear written expression of opinion on the financial information. In order to express such an opinion, the auditor should review and assess the conclusions drawn from the audit evidence obtained by him. This review and assessment involves forming an overall conclusion as to whether:
- (i) the financial information has been prepared using acceptable accounting policies, which have been consistently applied;
 - (ii) the financial information complies with relevant regulations and statutory requirements;
 - (iii) the view presented by the financial information as a whole is consistent with the auditor's knowledge of business environment; and
 - (iv) there is adequate disclosure of all matters relevant to the proper presentation of financial information.

The opinion expressed by an auditor may be unqualified, adverse, qualified or a disclaimer of opinion depending upon the degree of satisfaction of the auditor about the overall truth and fairness of the financial statements.

An adverse opinion should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements. Such an opinion is issued when the effect of disagreement is so material and pervasive to financial statements that the auditor concludes that a qualification of his report is not adequate to disclose the misleading or incomplete picture of the financial statements. This conclusion can be reached by the auditor in an extreme case where there had been flagrant violation of the accounting principles or evidence is not available for material transactions or within the knowledge of the auditor there exists material concealment or misstatement about financial affairs. He must have strong and convincing evidence in favour of his conclusion. It should be appreciated that this opinion is also an overall opinion and owes direct relationship to the portrayal of the financial position in the accounting statements. If one or two illegal transactions of not much significance have taken place and they have been fairly presented and disclosed in the accounting statements, it can not be held that the accounting statements are not true and fair. They are true and fair subject to the illegality already disclosed. The audit report stating that the accounts do not show a true and fair view is indeed an extreme and rare case. In case an auditor has to report to that effect, there must exist reservations on the accounts affecting materially the accounts taken as a whole. The reservation should not be such that it only partially affects the accounts. Also, mere reservation in the mind of the auditor is not enough, he must have convincing and definite evidence to state that the accounts are so materially irregular that they do not show a true and fair view.

AAS 28 (SA 700), "The Auditor's Report on Financial Statements" requires that a disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and is, accordingly, unable to express an opinion on the financial statements. A limitation may be imposed by circumstances, for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories. It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion. This would also be the case when internal control is so weak as to prevent the auditor from putting any reliance on the accounts. Therefore, to be fair and just, he should state that he is unable to form an opinion as to whether or not accounts give a true and fair view, for example, when the auditor was not able to examine a substantial part of the books of accounts because they were in police custody. In both the situations, the auditor should give also his reasons for the report he makes. Instances in which the auditor faces limitations on the scope of his work, it is appropriate for him to state that he has not been able to form an opinion.

- (b) The objective of a compilation engagement is to use accounting expertise, as opposed to auditing expertise, to collect, classify and summarise financial information. This ordinarily entails reducing detailed data to a manageable and understandable form without the requirement to test the assertions underlying that information. The procedures employed are not designed and do not enable the member to express any opinion on the financial information. Therefore, it is essential that the member clearly brings out the nature of association with the financial statement and the nature of the work performed by him. The following may be noted in this regard.
- i. The title of the report should be "Accountant's Report on Unaudited Financial Statement and not An Auditor's Report".
 - ii. The report should be addressed to the appointing authority.
 - iii. The report should identify the financial information compiled, also stating that it is based on the information provided by the management.
 - iv. The report should clearly state that the financial statements are not audited.
 - v. In describing the engagement, ambiguous terms such as review, general review, check, etc. should not be based.
 - vi. Date of the Report should be mentioned.
 - vii. Name and address of the firm of the member appointed for carrying out the compilation engagement should be mentioned.
 - viii. Signature and the designation (sole proprietor/ partner) and membership number should appear in the report.

9. (a) (i) Drafts paid without advice: This balance is in the nature of a suspense account in as much as it represents payments made on account of drafts issued by other branches but for which the relevant advice from those branches have not been received. It is, therefore, most important to examine the system of internal control operating in the bank in this respect. The testing of the internal control system has to be made mainly with regard to the following:

- (i) the system of verifying the authenticity of the draft by reference to specimen signature of the signing authority and the prima facie correctness and completeness of the draft in all respects;
- (ii) the system of co-relating drafts paid with advices subsequently received; and
- (iii) the system of sending reminders where advices are not received within a reasonable time and the recording of reasons for their non receipt.

The composition of the balances appearing in this account should be verified with particular reference to any long outstanding items. The auditor should also verify whether the items appearing in this account have been subsequently cleared on receipt of the relevant advices. It would also be useful to have on record the names and addresses of the payees of such drafts. The auditor may also seek confirmation of transactions relating to such outstanding cases.

- (ii) Branch Adjustment Account: In the final balance sheet of the Bank, this balance represents the difference between inter branch debits and credits and should normally comprise items which are in transit as on the closing date. This account is the one which is most commonly used by unscrupulous persons in committing a fraud. The verification of this account is, therefore, of great importance. The procedure for verification is as follows:

- (a) See that all branch accounts are periodically reconciled.
- (b) Check all adjustments in the account and ensure that the adjustments are done properly and supported by adequate documentary evidence as to its validity.
- (c) Verify that reversal entries are made under proper authority and after due explanation and evidence.

- (b) (i) Advances to DOT COM Companies

- (1) Evaluate the efficacy of internal control system in general to ascertain whether an advance is made only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank. The sanction for an advance must specify, among other things, the limit of borrowing, nature of security,

margin to be kept, interest, terms of repayment, etc. Also see that all the necessary documents, e.g., agreements, demand promissory notes, letters of hypothecation, etc. have been executed by the parties before advances are made.

- (2) Examine loan documents such as certificate of commencement of business (in the case of public limited companies), resolution of board of directors, and resolution of shareholders (in cases covered by section 293(1)(d) of the Companies Act, 1956).
- (3) Verify the business plan of the company especially where the revenue model is in place. Verify whether the company depends only on outside funding or can self generate funds.
- (4) Examine in case the security is in the form of mortgage, apart from mortgage deed (in the case of English Mortgage) or letter of intent to create mortgage (in the case of Equitable Mortgage), the evidence of registration of the charge with the Registrar of Companies.
- (5) Review the operation of advance account to see that limit is not generally exceeded; that the account is not becoming stagnant; that the customer is not drawing against deposits which are not free from lien; that the account is not window-dressed by running down overdrafts at the year end and again drawing further advances in the new year, etc.
- (6) Examine whether there is a healthy turnover in the account. It should be seen that the frequency and the amounts of credits in the account are commensurate with the sanctioned limit and the nature and volume of business of the borrower. Any unusual items in the account should be carefully examined by the auditor. If the auditor's review indicates any unhealthy trends, the account should be further examined. The auditor's examination should also cover transactions in the post-balance sheet date period. Large transactions in major accounts particularly as at the year-end may be looked into to identify any irregularities in these accounts.
- (7) Review periodic statements, cash flow statements, latest financial statements, etc. to assess the recoverability of advances.
- (8) Verify whether the advance is secured and determine whether the security is legally enforceable, i.e., whether the necessary legal formalities regarding documentation, registration, etc., have been complied with; whether the security is in the effective control of the bank; and to what extent the value of the security, assessed realistically, covers the amount outstanding in the advance.
- (9) Ensure that proper provisioning norms have been applied in view of non-observance of terms, coupled with irregular payment of interest and default in repayment of installments, if any.

- (ii) Balances in Account of a Bank situated in a Foreign Country
 - (1) Verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at the year-end.
 - (2) Review the reconciliation statements and pay particular attention to the following.
 - (i) Examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to revenue for the year have been so taken. This should be particularly observed when the bills collected, etc., are credited with net amount and entries for commission, etc. are not made separately in the statement of account.
 - (ii) Examine that no cheque sent or received in clearing is outstanding. As per the practice prevalent among banks, any cheques returned unpaid are accounted for on the same day on which they were sent in clearing or on the following day.
 - (iii) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.
 - (3) Examine the large transactions in inter-bank accounts, particularly towards the year-end, to ensure that no transactions have been put through for window-dressing.
 - (4) Check original deposit receipts in respect of balances in deposit accounts in addition to confirmation certificates obtained from banks in respect of outstanding deposits.
 - (5) Check whether these balances are converted into the Indian currency at the exchange rates prevailing on the balance sheet date and ensure compliance with AS-11 on "Accounting for the Effects of Changes in Foreign Exchange Rates".
10. (a) Verification of Premiums: In the audit of a general insurance company, verification of premium is one of the most important aspects for the statutory auditor. The following procedure should normally be applied for verification of premium:
- (i) Ascertain that all the cover notes relating to the risks assumed have been serially numbered for each class of business.
 - (ii) Ensure that the premium in respect of risks starting during the relevant accounting year has been accounted as premium income of that year but pertaining to risk commencing in the following year has been accounted as "Premium Received in Advance".
 - (iii) Verify the collections lodged by the agents after the balance sheet date to see whether any collection pertains to risk commencing for the year under audit.

The auditor should also check that the premium has been recorded originally at the gross figure without providing for unexpired risks and re insurances.

- (iv) In case of co-insurance business, the auditor should see that the company's share of premium has been accounted for on the basis of the available information on nature of risk and the provisional premium charged by the leading insurer.
 - (v) Check whether premium register have been maintained chronologically, for each underwriting department, giving full particulars including service tax charged as per acceptance advise on the day to day basis.
 - (vi) Verify the year-end transactions to check that the amounts received during the year in respect of risks commencing or installments falling due on or after the first day of the next financial year are not credited to premium account but to Premium Received in Advance Account.
 - (vii) Verify the collections remitted by the agents after the cut-off date to verify the risks assumed during the year for those collections. If the premium originally received has been refunded, the auditor should verify whether the agency commission paid on such premium has been recovered from the agent.
- (b) Verification of Re-insurance outward:
- 1. Verify that re-insurance underwriting returns received from the operating units regarding premium, claims, paid, outstanding claims, tally with the audited figures of premium claims paid and outstanding claims.
 - 2. Check whether the pattern of re-insurance underwriting for outward cessions fits within the parameters and guidelines applicable to the relevant year.
 - 3. Check whether cessions have been made as per the stipulation applicable to various categories of risk.
 - 4. Verify whether the cessions have been made as per the agreements entered into with the various companies.
 - 5. See whether the outward remittances to foreign re-insurance have been done as per the foreign exchange regulations.
 - 6. Ascertain whether the commission has been calculated as per the terms of the agreement with the re-insurance.
 - 7. Verify the computation of profit commission by various treaty arrangements in the figure of the periodical accounts rendered and in relation to outstanding less pertaining to the treaty.
 - 8. Examine whether the cash loss recoveries have been claimed and accounted on a regular basis.

9. Verify whether the claims paid items appearing outstanding claims list by ever. This can be verified at least in respect of major claims.
 10. See whether provisioning for outstanding losses recoverable on cessions have been confirmed by the re-insurers and in the case of major claims, documentary support was insisted and verified.
 11. Accounting aspects of the re-insurance cession premium commission recoverable, paid claims recovered and outstanding losses recoverable on cessions have to be checked.
 12. Check percentage pattern of gross to net premium, claim paid and outstanding claim to ensure comparative justifications.
11. (a) True and Fair Cost of Production: The concept of "True and Fair Cost of Production" is used in the context of cost audit wherein the cost auditor has to state whether in his opinion the company's cost accounting records have been kept so as to give a true and fair view of the cost of production, processing and marketing of the product. A cost auditor checks the cost accounting records to verify that the cost statements are properly drawn up as per the records and that they present a true and fair view of the cost of production and marketing of various products dealt with by the undertaking. The following are the relevant considerations in determining whether the cost of production determined by the cost auditor is true and fair:
- ◆ Determination of cost following the generally accepted cost accounting principles
 - ◆ Application of the costing system appropriate to the product
 - ◆ Materiality
 - ◆ Consistency in the application of costing system and cost accounting principles
 - ◆ Maintenance of cost records and preparation of cost statements in the prescribed form and having the prescribed contents
 - ◆ Elimination of material prior-period adjustments
 - ◆ Abnormal wastage's and losses and other unusual transactions being ignored in determination of cost.
- It as a result of the examination of the books of account, the cost auditor desires to give a qualified report he shall indicate the extent to which he has to qualify the report and the reasons therefor.
- (b) Reconciliation of Cost and Financial Accounts: A cost auditor is ultimately required to express an opinion as to whether the company has maintained proper cost accounting records so as to give a true and fair view of cost of production etc. In arriving at this opinion, the cost auditor is required to ascertain about multitude of information such as cost of raw materials consumed, cost of power and scrap fuel cost of stock, employer costs, provision for depreciation, royalty and technical

payment, abnormal cost, etc. Annexures to the cost audit reports requires detailed information in respect of financial position including capital employed, net worth, profit, net rates, operating profit, unit cost of power and fuel, total wages and salaries etc. It is obvious therefore that cost audit cannot be done without reference to financial books, more so in the context of the statutory requirement to have a statement of reconciliation with financial accounts as part of cost audit report. Further the cost statements are to contain a summary of all expenditure incurred by the company and the share in such expenditure attributable to the activities covered by Cost Accounting Records Rules; Overhead expenditure also needs allocation between activities covered by rules and activities not so covered. Naturally this can be done only with reference to financial ledger. Under Part II of Schedule VI to the Companies Act, 1956, quite a few matters which are to be mentioned in the Profit and Loss Account of the company are also to be covered in cost statements such as consumption of raw materials in quantity and value, sale of finished goods under classified headings in quantity and nature, actual production quantity of value, inventory in quantity of value for each class of goods, etc. A correlation between consumption of raw materials as per cost records and financial records may throw up the need for inquiry into errors, mistakes and manipulation. Material discrepancy between financial records and cost records will be highlighted in the reconciliation statement which would require that the cost auditor may examine deviation before reporting on the same. Thus it is imperative for the cost auditor to refer to financial records.

- (c) 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.

12. The American company engaged in the business of manufacturing and distribution of industrial gases wishing to acquire a listed Indian company has commissioned the Due Diligence Audit to assess the strengths and weaknesses of this company. It is quite important for the acquirer to assess the proposal from different angles and specifically as per terms of the assignment and also see whether proposed merger would create operational synergies. On the other hand, financial due diligence review would be performed after the commercial valuation. Accordingly, while a preliminary review might be performed during initial stages of the restructuring exercise and may, in fact, be performed simultaneously with the commercial evaluation, at a later stage, financial due diligence may be performed on the books of account and other information directly pertaining to the financial matters of the entity. In addition, a legal due diligence may be required where legal aspects of functioning of the entities are reviewed; for example, the legal aspects of property owned by the entity or compliance with various statutory requirements under various laws. Like other due diligence exercises, environmental and personnel due diligence are also carried out in order to establish whether various propositions with regard to environment and personnel of the enterprise under review are appropriate. In any case, it is quite important to look behind the veil of initial information provided by the company and to assess the benefits and costs of the proposed acquisition/merger by inquiring into all relevant aspects of the past, present and future of the business to be acquired. Some of the significant key areas which shall be covered under the review are as under:

- (1) Historical Background: The accountant should begin the financial due diligence review by looking into the history of the company and the background of the promoters. The details of how the company was set up and who were the original promoters has to be gone into, before verification of financial data in detail. An eye into the history of the company may reveal its turning points, survival strategies adopted from time to time, the market share enjoyed by and changes therein, product life cycle and adequacy of resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the said company. This could, inter alia, include the nature of business(es), location of production facilities, warehouses, offices, products or services and markets.
- (2) Significant Accounting Policies: The accounting policies being followed by the company and the appropriateness thereof is another key area. The impact of the recent changes in the accounting policies in the recent past keeping in view its intention of offering itself for sale. The accountant has to look at the main effect of accounting policies on the overall profitability and their correctness. It is also quite important to ascertain significant accounting policies used by the company, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the company are different from those adopted by the acquiring enterprise and the effect of such differences. Finally,

examine whether the financial statements of the company have been prepared in accordance with the governing statutory requirements.

- (3) **Review of Financial Statements:** An evaluation of the profit reported by the company would be largely based upon its operating results. Any extraordinary item of income or expense that might have affected the operating results would require close examination. It is advisable to compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period. It is important that the trading results for the past four to five years are compared and the trend of normal operating profit arrived at. The normal operating profits should further be benchmarked against other similar companies. Besides the above, and based on the trend of operating results, the accountant has to advise the acquiring enterprise, through due diligence report, on the indicative valuation of the business. The exercise to evaluate the balance sheet of the company has to take into consideration the basis upon which assets have been valued and liabilities have been recognised. The net worth of the business has to be arrived at by taking into account the impact of over/under valuation of assets and liabilities.
- (4) **Cash Flow:** A review of historical cash flows and their pattern would reflect the cash generating abilities of the company and should highlight the major trends. It is important to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time. It is necessary to check:
 - (a) Whether the company is able to honour its commitments to its creditors, to the banks, to government and other stakeholders;
 - (b) How well is the company able to turn its debtors and stocks;
 - (c) How well does it deploy its funds; and
 - (d) Whether any funds are lying idle or is the company able to reap maximum benefits out of the available funds.
- (5) **Financial Projections:** The projections for the next five years with detailed assumptions and workings and the appropriateness of assumption used in the preparation and presentation of financial projections. If the accountant is of the opinion that as assumption used by the company are unrealistic, the accountant should consider its impact on the overall valuation of the company.
- (6) **Human Resources:** In the Indian context, the status of work force, staff and employees is a complex problem. It is important to work out how much of the labour force has to be retained. It is also important to judge the job profile of the administrative and managerial staff to gauge which of these match the requirements of the new incumbents. The aspects whether all employee benefits like PF, Gratuity, ESI and superannuation have been properly paid/funded. The pay

packages of the key employees will be thoroughly reviewed since this can be a crucial factor in future employee costs.

- (7) Statutory Compliance: This is one area that has to be examined in detail. It is important to make a list of laws that are applicable to the entity as well as to make a checklist of compliance required from the company under those laws. If the company has not been regular in its legal compliance, it could lead to punitive charges under the law. The impact on such violations be quantified and assessed in respect of entity; financial status and even on its governing concern status.

Contents of a Due Diligence Report: Briefly, the contents of a due diligence report can be discussed under:

- ◆ Terms of reference and scope of verification
- ◆ Objective of due diligence
- ◆ Brief history of the company including shareholding pattern
- ◆ Assessment of management structure
- ◆ Assessment of financial liabilities with special emphasis on Interlocking investments and financial obligations with group/associates companies, amounts receivables subject to litigation, any other likely liability which is not provided for in the books of account.
- ◆ Assessment of valuation of assets including comments on properties, terms of leases, lien and encumbrances including status of charges, liens, mortgages, assets and properties of the company.
- ◆ Assessment of operating results
- ◆ Assessment of taxation and statutory liabilities
- ◆ Assessment of possible liabilities on account of litigation and legal proceedings against the company and suggestion on ways and means including affidavits, indemnities, to be executed to cover unforeseen and undetected contingent liabilities.
- ◆ Assessment of net worth
- ◆ Suggestions on various aspects to be taken care of before and after the proposed merger / acquisition.
- ◆ Status of franchises, license and patents.

Finally, an executive summary may be prepared highlighting the significant areas.

13. (a) Management Audit Questionnaire: A management audit questionnaire is an important tool for conducting the management audit. It is through these questionnaires that the auditors make an inquiry into important facts by measuring current performance. Such questionnaires aim at a comprehensive and

constructive examination of an organisation's management and its assigned tasks. Overall it is concerned with the appraisal of management actions in accomplishing the organisation's objectives. Its primary objective is to highlight weaknesses and deficiencies of the organisation. It includes a review of how well or badly the management functions of planning, organising, directing and controlling are being performed. In addition it evaluates how effective the decision-making process is in accomplishing the stated organisation objectives. Within this framework, the questionnaire provides a means for evaluating an organisation's ongoing operations by examining its major functional areas. There are three possible answers to the management audit questions: "Yes", "No" and "N.A.", (not applicable). A "Yes" answer indicates that the specific area, function, or aspect under study is functioning in an acceptable manner; no written explanation is needed in that case. On the other hand, a "no" answer indicates unacceptable performance and should be explained in writing. Questionnaire comments on negative answers not only provide documentation for future reference, but, more important, provide background information for undertaking remedial action. Those questions that are not applicable and should be ignored in the audit are checked in the "N.A." column. The management audit questionnaire does not give answers, but simply asks questions. If all questions are answered with a 'yes', operations are proceeding as desired. On the other hand, if there are one or more 'no' answers, difficulties are being experienced and must be explained in writing. If the question does not apply, the N.A. (not applicable) column is checked. Thus, management audit questionnaire for this part of the audit not only serves as a management tool to analyse the current situation; more importantly, it enables the management auditors to synthesise those elements that are causing organisational difficulties and deficiencies.

Audit of Inventory

A management audit questionnaire for audit of inventory is given below:

Long Range Plans

- ◆ Is inventory management sufficiently qualified to meet long-range company objectives?
- ◆ Are long-range inventory management plans coordinated with: production, purchasing and finance?
- ◆ Is inventory properly and efficiently stored to reduce obsolescence, pilferage, etc.
- ◆ Is there an adequate system to plan inventory in the long run at optimum levels?
- ◆ Are inventory plans and procedures audited periodically?

Short or Medium Range Plans

- ◆ Is inventory management sufficiently qualified to meet short or medium range objectives?
- ◆ Are inventories under control as to type and amount?
- ◆ Are short-range inventory management plans an integral part of production and purchasing?
- ◆ Is there an adequate inventory system to plan current inventory at optimum levels detect theft and compare physical to perpetual inventories?
- ◆ Are lead times figured into inventory levels for purchasing and manufacturing?
- ◆ Are reorder levels set?
- ◆ Do the plans include 'make' or 'buy' decisions to lower costs?

Organisation Structure

- ◆ Is the inventory department under directions of a suitable person?
- ◆ Are the inventories and their in-plant movements organised and reported by their basic types, i.e., raw materials, work in progress and finished goods?
- ◆ Is there an effective system of physical inventory to disclose any irregularities or losses?
- ◆ Is the ABC analysis followed for the inventory control?

Communication

- ◆ Is there an information system utilised that employs efficient management, methods and techniques to control inventories and to prepare periodic inventory reports that are of great value to management?
- ◆ Is there an effective communication system designed to assist in, keeping the inventory turnover rate high?
- ◆ Is there good managerial control over movement of work-in-process materials so that this inventory is kept at a minimum?

Control

- ◆ Are inventory management control reports, methods and techniques integrated with production and purchasing?
- ◆ Are inventories properly stored to provide a minimum of:
 - a. obsolescence?
 - b. deterioration?
 - c. pilferage?

- ◆ Is inventory control integrated with:
 - a. economic order quantities?
 - b. re-order points?
 - ◆ Have steps been taken to balance the cost generated by too small an inventory against the cost of carrying excessive inventories to determine an optimum inventory turnover?
 - ◆ Are inventory items physically counted to make sure that perpetual inventory records are accurate?
 - ◆ Is inventory controlled through the use of the ABC concept (A = high-value items, B = medium-value items, C = low-value items)?
 - ◆ Is there an effective management control system for receiving materials that are not on a purchase order, i.e., products returned by customers?
- (b) Internal auditing is an activity carried out by the internal staff of the organisation to meet the management requirements of information. The definition of internal auditing as given by the Institute of Internal Auditors of New York, in fact, is so wide in its scope that it covers both operational and management auditing. According to the Institute of Internal Auditors, "the overall objective of internal auditing is to assist all members of management in the objective discharge of their responsibilities, by furnishing them with objective analysis, appraisals, recommendations and pertinent comments concerning the activities reviewed. The internal auditor, therefore, should be concerned with any phase of business activity wherein he can be of service to organisation". According to the definition, the overall objective of internal auditing is to assist all members of management in the objective discharge of their responsibilities, by furnishing them with objective analysis, appraisals, recommendations and relevant comments concerning the activities reviewed. The internal auditor, therefore, should be concerned with any phase of business activity wherein he can be of service to the organisation. Naturally, when an auditor is concerned with the appraisal of operations, he would be performing the role of an operational auditor.

Another important point that this definition throws up is that operational auditing is essentially a function of internal auditing staff. Traditionally, the internal auditing was concerned with the financial transactions only. It was during early 1940's, the concept of operational auditing came into existence. According to Cadmus "operational auditing is not different from internal auditing, it is merely an extension of internal auditing into operational areas. It is characterised in both financial and operational areas – by the auditor's approach and state of mind". The main objective of operational auditing is to verify the fulfilment of plans and sound business requirements as also to focus on objectives and their achievement as against the performance yardsticks evident from in the management objectives,

goals and plans, budgets records of past performance, policies and procedures. Industry standards can be obtained from the statistics provided by industry, associations and government sources. It should be appreciated that the standards may be relative depending upon the situation and circumstances; the operational auditor may have to apply them with suitable adjustments. It might appear from the above that an internal auditor is not concerned with operational aspects and operational auditor is, not concerned with financial aspects which is not so . Because traditionally, internal auditors had been engaged in a sort of protective function, deriving their authority from the management. They examined internal controls in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are not there; they checked the accounting books and records to see, whether the internal checks are properly working and the resulting accounting data are reliable. They also looked into the aspect of safety of the assets and properties of the company.

Some element of operational auditing could be found even in these traditional functions of internal auditors, specially in the context of fraud, wastage and loss. Internal auditors emboldened by their ability to appraise financial and accounting control gradually started extending their field to cover non-accounting control as well. On the other hand, it should not be assumed, that, since an operational auditor is concerned with the audit of operations and review of operating conditions, he is not concerned with the financial aspects of transaction and controls. A point has already been made that the special expertise acquired by the operational auditor, that enables him to view the controls and operations from the management point of view, can be carried back to his review of the financial areas. In the matter of cash transactions, the operational auditor will look into such aspects as the quantum of cash in hand (by relating it to the requirement of cash to be held) carried generally or the use of cash not immediately required. Also he will review the operational control on cash to determine whether maximum possible protection has been given to cash. Similarly, in the audit of stocks, he would have management policy. In pure administrative areas on stock, he will see whether adequate security and insurance arrangements exist for protection of stocks.

Thus, over a period of time, the scope of internal auditing was widened to cover not only accounting and financial operations but other operations such as marketing, personnel, production, etc. As per the modern definition of internal auditing, there is no difference between the two. However, still some auditors believe that there might exist difference between the two on account of perception as far as scope of the two is concerned which in fact is not true as evident from the foregoing analysis.

14. (a) Compliance Procedures and Evaluation of Internal Controls: AAS-1 (SA 200) on "Basic Principles Governing an Audit" states that, "the auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information. According to it, compliance

procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. Obtaining audit evidence from compliance procedures is intended to reasonably assure the auditor in respect of the following assertions :

- Existence - that the internal control exists.
- Effectiveness - that the internal control is operating effectively.
- Continuity - that the internal control has so operated throughout the period of intended reliance.

The auditor formulating his opinion on financial information needs reasonable assurance that transactions are properly authorised and recorded in the accounting records and that the transactions have not been omitted. Internal controls, even if fairly simple, may contribute to the reasonable assurance the auditor seeks. The auditors' objective in studying and evaluating internal controls is to establish the reliance he can place thereon in determining the nature, timing and extent of his substantive auditing procedures.

Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in place and are also effective. Compliance procedures enable the auditor to determine the existence, effectiveness and continuous operation of the internal control system. These procedures include tests requiring inspection of documents supporting transactions to gain evidence that controls have operated properly. For example, the auditor may see that the documents have been properly authorised. The auditor may also make enquiries about the observation of controls, for example, determining who actually performs each function not merely who is supposed to perform it. Compliance procedures are conducted by the auditor to gain evidence that those internal controls on which he intends to rely operates generally as identified by him and they function effectively throughout the period of intended reliance. The concept of effective operation recognises that some deviations from prescribed controls may have occurred.

Based on the results of his compliance procedures, the auditor evaluates whether the internal controls are adequate for his purpose. If based on the results of the compliance procedures, the auditor concludes that it is not appropriate to rely on a particular internal control to the degree previously contemplated, he should ascertain whether there is another control which would satisfy his purpose and on which he might rely (after applying appropriate compliance procedures). Alternatively, he may modify the nature, timing or the extent of his substantive audit procedures.

- (b) A flow-chart is a graphic presentation of the flow of transactions and documents in an organisation. Evaluation of the internal controls forms an important part of the auditing process as it enables the auditor to know the weaknesses and strengths of

the accounting system and consequently the general reliability of the accounting records and data emanating therefrom. Also, it helps the auditor to decide upon the relative audit thrust needed in the different accounting areas. A properly drawn up flow chart can provide a neat visual picture of the whole activities of the section or department involving flow of documents and activities. More specifically it can show:

- (i) at what point a document is raised internally or received from external sources;
- (ii) the number of copies in which a document is raised or received;
- (iii) the intermediate stages set sequentially through which the document and the activity pass;
- (iv) distribution of the documents to various sections, departments or operations;
- (v) checking authorisation and matching at relevant stages;
- (vi) filing of the documents; and
- (vii) final disposal status.

Different methods are available with the auditor to evaluate the internal controls but the flow-charting method is, perhaps, the most scientific and advantageous as compared to other methods. It provides the most concise but comprehensive way of recording the operating controls along with the flow of transactions and documents. In the flow-chart, a total and complete visual picture and control system is available and as such its reception in the human mind is direct. In drawing a flow-chart, organised and concentrated application of mind is essential to reflect the control system in a rational manner. Even in a large and complex organisation, the control system could be depicted by few sheets of neatly drawn flow-charts. However, in drawing the flow chart, the auditor has to take few precautions, e.g., flow-charts should not be lengthy and cumbersome, should be neat, should portray the flow completely with final disposal of papers and there should be proper use of symbols and lines. The auditor will be able to visually correlate the functions and the related controls and assess the adequacy and effectiveness thereof much quickly than a possibly in any other method.

15. (a) Section 225(3) of the Companies Act, 1956 permits a retiring auditor to make a representation in writing (not exceeding a reasonable length) to the company. The proposition of the partner to highlight contributions made by the firm in strengthening the control procedures in the representation is not acceptable because the representation letter should not be prepared in a manner so as to seek publicity. The Code of Ethics issued by the Institute makes it amply clear that the right to make representation does not mean that an auditor has any prescriptive right or a lien on an audit. The wording of his representation should be such that, apart from the opportunity not being abused to secure needless publicity, it does not tantamount directly or indirectly to canvassing or soliciting for his continuance as an

auditor. The letter should merely set out in a dignified manner how he has been acting independently and conscientiously through the term of office and may, in addition, indicate if he so chooses his willingness to continue as auditor if re-appointed by the shareholders. Thus, such action proposed by a partner could not be approved since, it would lead to his being held guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

- (b) Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits solicitation of client or professional work either directly or indirectly by circular, advertisement personal communication or interview or by any other means since it shall constitute professional misconduct. The bio-data was handed over to the chairperson during the T.V. interview by the Chartered Accountant which included details about the firm and the achievements of the partner as an expert in the field of taxation. The chairperson simply read out the same in detail about association with the international firm as also the achievements of the partner and his recognition as an expert in the field of taxation. Such an act would definitely lead to the promotion of the firms' name and publicity thereof as well as of the partner and as such the handing over of bio-data cannot be approved. The partner would be held guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.
- (c) Professional services cannot and should not be offered under an agreement which entails that fees shall be payable on a success fee basis. The fees payable, therefore, become contingent in nature. It is obvious that a person who is to receive payment in direct proportion to the benefit received by his client, may be tempted to exaggerate the advantage of his service or may adopt means which are not ethical. It will have the effect of undermining his integrity and impairing his independence. Therefore, the remuneration based on a percentage of the profits or on the happening of a particular contingency such as, the successful outcome of an appeal in revenue proceedings is prohibited. Therefore, the action of the firm to quote fees in such a manner on the advice of the Chairman of the Audit Committee to ensure their appointment could not be accorded approval and the member would be held guilty of professional misconduct under Clause (10) of Part I of the Chartered Accountants Act, 1949.

In the instant case, the Chairman of Audit Committee who also happens to be a chartered accountant would also be guilty of misconduct under the Chartered Accountants Act, 1949.

- (d) The Council of the Institute of Chartered Accountants of India has categorically stated that in cases where a member is a Director of a company, the firm in which the said member is a partner, should not express any opinion on its financial statements. Clause 4 of Part I of the Second Schedule desists a chartered accountant to express opinion on financial statements of an enterprise in which he,

his firm or a partner in his firm has a substantial interest unless he discloses the interest in his report. Since the firm has been appointed to evaluate the costs of the various products manufactured by it for their information system, it cannot be construed to be a misconduct under Clause (4) Part I of the Second Schedule to Chartered Accountants Act, 1949.

16. (a) The RBI requires banks to adhere to certain capital adequacy norms to ensure that they have adequate capital in relation to the credit and other risks undertaken by them. In accordance with the circular issued by the RBI, while computing risk adjusted value of assets netting may be done only for advances collateralised by cash margins or deposits and in respect of assets where provision for doubtful debts have been made. The circular further states that in calculating the aggregate of funded and non-funded exposure of a borrower for the purpose of assignment of risk weight, banks may "net off" against the total outstanding exposure of the borrower, credit balance in current account which are free from any lien. Accordingly the treatment of netting off followed by the bank is in order.
- (b) It is not a prudent practice to treat dividend on shares of corporate bodies and units of mutual funds as income unless these are actually received. Accordingly, income from dividend on shares of corporate bodies and units of mutual funds should be booked on cash basis. In respect of income from government securities and bonds and debentures of corporate bodies, where interest rates on these instruments are pre-determined, income could be booked on accrual basis, provided interest is serviced regularly and as such is not in arrears. It was further, however, clarified that banks may book income on accrual basis on secure ties of corporate bodies/public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the central government or a state government. Banks may book income from dividend on shares of corporate bodies on accrual basis, provided dividend on the shares has been declared by the corporate body in its annual general meeting and the owner's right to receive payment is established. This is also in accordance with AS-9 as well. In the instant case, the recognition of income by the bank on accrual basis is not in order
- (c) The bank is a consortium member of cash credit facilities of Rs.50 crores to X Ltd. Bank's own share is Rs.10 crores only. During the last two quarters against a debit of Rs.1.75 crores towards interest, the credits in X Ltd's account are to the tune of Rs.1.25 crores only. Sometimes, several banks form a group (the 'consortium') under the leadership of a 'lead bank' to make advance to a large customer on same conditions and security with proportionate rights. In such cases, each bank may classify the advance given by it according to its own experience of recovery and other factors. Since in the last two quarters, the amount remains outstanding and, thus, interest amount should be reversed. This is despite the certificate of lead bank to classify that the account as performing. Accordingly, the amount should be shown as non-performing asset.

- (d) It is wrong to take the Balance Sheet date for purposes of classification. In this context, it is important to note the concept of past due. An amount should be considered as past due when it remains outstanding for 30 days beyond due date. For example, if any SSI loan amount, the repayment of term loan instalment falls due for payment on December 31 and is not paid; the amount would become past due if it remains unpaid for 30 days beyond that date. In case of terms loans, if interest or instalment of principal is in arrears for any two quarters out of four quarters although default may not be continuously for two quarters during the year by applying past due test, it should be classified as non-performing asset and from that date provision should be made. In the case of other advances, outstanding in the last two quarters would be enough to classify the amount as such non-performing asset if no transaction appears in the last two quarters.

As per RBI Circular dated January 29, 1997, if the account of the borrowers have been regularised before the balance sheet date by repayment of overdue amounts through genuine sources and not by sanction of additional facilities, the account need not be treated as NP A inspite of payment of interest and installment were in arrear for two quarters. Bank should, however, ensure that the account remains in order subsequently and a solitary credit entry made in the account on or before the balance sheet date which extinguished the overdue amount of interest or instalment of principal is not reckoned as the sole criterion for treating the account as a standard asset.

It has been further clarified that in respect of accounts where there are potential threats of recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, it will not be prudent for banks to classify them first as sub-standard and then as doubtful after expiry of two years from the state of account has become NPA. It should be straight way classified as doubtful asset or loss asset, as appropriate, irrespective of the period for which it has remained as NPA.

17. (a) Section 10(33) of the Income-tax Act, 1961 provides exemption in respect of income received in respect of units from Unit Trust of India to all assesseees including a public charitable trust. Hence, Rs.10 lakhs received from Unit Trust of India is not taxable income of the trust. The Income-tax Act, 1961 requires that for claiming full exemption by the trust, it is required to apply at least 75% of such income during the previous year for charitable or religious purposes. As per the facts given, the trust has applied only Rs.7 lakhs i.e. 70% of its total income towards the trust objects and, thus, contravened the requirements of the Act. Yet the trust shall not be required to pay tax on its income because the income has been received on account of units which in any case is fully exempt under the Income-tax Act, 1961. Accordingly, the trust is not required to make any provisions for tax in the accounts. The fact that not spending Rs.3 lakhs out of Rs.10 lakhs, though contravening the requirement of spending at least 75% of "income" would, therefore, not attract tax.

Hence, no tax provision is necessary.

The tabular presentation of the statement of income is given below :

(a) Revenue Statement: UTI Income – Exempt u/s 10(33) Rs.10,00,000

(b) Statement of Total Income:

UTI income [exempt under section 10(33)]	10,00,000
Less: Spent on Trust's objects	<u>7,00,000</u>
Amount unspent	3,00,000
Accumulation allowable @ 25% of Rs.10,00,000	<u>2,50,000</u>
Balance	50,000
Less: Not taxable as UTI income is exempt	50,000
Taxable Income	<u>NIL</u>

- (b) Receipt of Tax Audit Fees in Advance: Under section 226(3)(d) of the Companies Act, 1956, a person is disqualified from being an auditor if he is indebted to the company for more than Rs.1,000. This provision for disqualification would apply only in case of an auditor appointed under the Companies Act, 1956. The intention of the Companies Act, 1956 is to ensure that the auditor is not under any financial obligation of the company.

When a chartered accountant is appointed to conduct a tax audit u/s 44AB of the Income Tax Act, 1961, his appointment is not under the Companies Act, 1956 but under the Income Tax Act, 1961. In the Income Tax Act, 1961 there is no such provision for a person to be disqualified on his becoming indebted to the company. Thus in the instant case, though the entire audit fees are taken in advance, Mr. X would still be able to carry out the audit and he would not be disqualified. However, having regard to be professional ethics in general an auditor must avoid such situations and may consider disclosing the same.

- (c) Export Payments to a Relative: Clause 18 of Form 3CD, annexed to the tax audit report in Form 3CA/3CB, requires the tax auditor to specify particulars of payments made to persons specified u/s 40(A)(2)(b) of the Income Tax Act, 1961. Persons specified in the said section are relatives of an assessee and sister concerns, etc. In the instant case, however, Mr. P has not made any payments to his brother. On the contrary, he must have received payments from him against exports made and, thus, this clause would not be applicable to him. Mr. P will nonetheless be still as a part of his normal audit planning would be required to verify whether the exports are genuine, i.e., whether the diamonds have been delivered by verifying the necessary delivery documents, relevant invoices, etc., the reasonableness of the price and whether the export realisations have been received.

Alternative Solution: Clause 26 requires section-wise details, if any, admissible under Chapter VIA of the Income Tax Act, 1961. Accordingly, the tax auditor is

required to give tax audit report in respect of deduction admissible under Chapter VIA with reference to the books of account of the entity audited by him. The auditor would also have to see that whether different admissible condition under the specified section, i.e., section 80HHC have been fulfilled or not. Under section 80HHC, the quantum of deduction in respect of export profit is on the basis of convertible foreign exchange having been received within a period of 6 months from the end of accounting year or extended period. In this context, the tax auditor has to verify that all export proceeds have been received by the assessee by 30th September and for this he has to ask the client to produce necessary bank certificate. Further, tax auditor should also refer to separate audit report while verifying the information's.

18. (a) Hit or Take Orders: Hit or take orders occur in screen-based trading in stock exchange. This is a variation of market orders. It allows for faster order execution without cluttering up the limit order book. This method converts the key strokes or mouse clicks of the broker into a limit order at the touch line price for a particular scrip, without his having to place a limit order. Further all unexecuted orders of this type are automatically killed and are therefore not stored in the order book.

A broker interested in a particular scrip would ask the system to display the touch line of that scrip. He would then operate certain predefined keys or mouse clicks which would be different for buy and sell orders. The system would ask the broker to identify the client (may be skipped) and to quantify the order. The system, would then convert his buy or sell order for the quantity specified into a limit order and attach the touchline offer price for a buy order or a touchline bid price for a sell order. This order will be matched against jobber quotes and the order book for the quantity can be executed. The unexecuted quantity, if any, will be killed and removed from the system.

- (b) Contract Notes: Contract note is a document through which a contractual obligation is established between a member and a client. The auditor should verify that the transactions done by a member are recorded in the sauda book. It should also be examined that contract notes are issued for all the business conducted on behalf of the client. The auditor should verify the list of traders executed with the bills raised. The auditor should apply appropriate audit procedures to satisfy himself that:
 - (i). Contract notes have been serially numbered
 - (ii). No serial number has been left blank.
 - (iii). Format of the contract note is as prescribed by the Regulations of the exchange.
 - (iv). Duplicates copies/counter foils of contract are maintained.
 - (v). Brokerage charged in contract notes is within the permissible limits and is indicated separately including service tax.

- (vi). Contract notes have been issued in respect of all transactions and signed by an authorised person.
 - (vii). Transaction identification, trade identification and trade execution time has been printed on the contract note issued.
 - (viii). SEBI Regulation number, settlement number and settlement dates have been mentioned.
 - (ix) PAN number of the member and client has been mentioned on contract note, if required.
 - (x). All clauses specified by the exchange have been printed on the reverse of the contract notes.
- (c) Rolling Settlement: A rolling settlement is one in which a transaction outstanding at the end of the day have to be settled within X number of business days from the transaction date. If a transaction is entered on Monday on T+2 rolling settlement, it will be settled on Wednesday when pay in or payout take place. SEBI has mandated most of the scripts to be settled exclusively on rolling settlement basis. Value at Risk (VaR) based margin approach has been adopted for transactions done in Compulsory Rolling Settlement. In the VaR system of margin, historical volatilities of scripts and overall market volatility is considered to arrive at a VaR margin percentage for a scrip. If a member fails to deliver the shares sold in rolling settlement, the exchange conducts an auction session to meet the shortfall credited by non-delivery of shares. If the auction price / close out price is less than the sale price, the difference is credited to Investor's Education and Protection Fund. If the sale price is less than the auction price / close out price, the difference is payable by the defaulters.
- (d) Sauda Book: All members of a stock exchange are required to maintain a 'Sauda Book', which contains details of all deals transacted by them on a day to day basis. This is a basic record, which each member is required to maintain regularly on day-to-day basis. It contains the details regarding the name of the code of the client on whose behalf the deals have been done, rate and quantity of bought or sold. These details are maintained date wise. This register contains all the transactions, which may be of any of the kind mentioned below :
- ◆ 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.

19. Auditor's Liability in case of Unlawful Acts or Defaults by Clients: The auditor's basic responsibility is to report whether in his opinion the accounts show a true and fair view and in discharging his responsibility he has to see as to how the particular situations affected his position. The general thinking with regard to unlawful acts or defaults by clients appears to be that the auditor should not 'aid or abet' but he is apparently not under any legal obligation to disclose the offence. A professional accountant would himself be guilty of a criminal offence if he advises his client to commit any criminal offence or helps or encourages in planning or execution of the same or conceals or destroys evidence to obstruct the course of public justice or positively assists his client in evading prosecution. A professional accountant in his capacity as auditor, accountant, or tax representative has access to a variety of information concerning his clients. On some occasions, he may acquire knowledge that his client has been guilty of some unlawful act, default, fraud, or other criminal offence. The duty of the professional accountant in such a case would depend upon the actual circumstances of the situation. Due consideration should be given to the exact nature of services that a professional accountant is rendering to his client, i.e. is he representing the client in income-tax proceedings or is he acting in the capacity of an auditor or an accountant or a consultant.

The Institute of Chartered Accountants of India has considered the role of chartered accountants in relation to taxation frauds by an assessee and has made the following major recommendations:

- (i) A professional accountant should keep in mind the provisions of section 126 of the Evidence Act whereby a barrister, an attorney, a pleader or a Vakil is barred from disclosing any communication made to him in the course of and for the purpose of his employment.
- (ii) If the fraud relates to past years when the accountant did not represent the client, the client should be advised to make a disclosure. The accountant should also be careful that the past fraud does not in any way affect the current tax matters.
- (iii) In case of fraud relating to accounts examined and reported upon by the professional accountant himself, he should advise the client to make a complete disclosure. In case the client refuses to do so, the accountant should inform him that he is entitled to dissociate himself from the case and that he would make a report to the authorities that the accounts prepared or examined by him are unreliable on account of certain information obtained later. In making such a report, the contents of the information as such should not be communicated unless the client consents in writing.
- (iv) In case of suppression in current accounts, the client should be asked to make a full disclosure. If he refuses to do so, the accountant should make a complete reservation in his report and should not associate himself with the return.

However, it can be argued that the auditor has a professional obligation to ensure that the client is fully aware of the seriousness of the offence and to seriously consider full disclosure of the matter.

It has been clearly established in various case laws that the auditor is expected to know the contents of documents and records and ascertain whether the affairs of the client are being conducted in an unlawful manner. It is in the course of the work, he comes across any unlawful acts, it is his duty to bring it to the notice of the client as also to make a disclosure in his report in appropriate cases. In this regard, one has to bear in mind the consequence of the act in relation to the professional code to which an auditor is subjected. Under the code, an auditor cannot disclose confidential information unless permitted by the client or unless required by law. Each case has to be judged on its circumstances. However, in every case he has to assess the implications of the unlawful act or default on the true and fair character of the accounting statements.

The question of liability of an auditor for unlawful acts or defaults by clients should be considered in the light of the broad parameters given above. However, it appears that if an auditor was aware of any unlawful act having been committed by client in respect of accounts audited by him and the unlawfulness was not rectified by proper disclosure or any other appropriate means, the auditor owes a duty to make a suitable report. If he does not, he may be held liable, if the true and fair character of the accounts has been vitiated.