

## **PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS**

### **QUESTIONS**

#### **Standards on Auditing, Statements and Guidance Note**

1. (a) The teeming and lading fraud was detected and the amount involved was subsequently deposited by the Executive Director of the company and, therefore, need not be reported upon.  
(b) “Auditor’s assessment of materiality may be different at the time of planning the engagement than at the time of evaluating the results of his audit procedures”. Discuss.
2. A Government of India undertaking, incorporated under the Companies Act, 1956 in the year 1987, is a dedicated financial institution engaged in the financing of power sector in India. The company is also notified as a public financial institution under section 4A of the Companies Act, 1956. The company is mainly engaged in providing loans and other non-fund based products to various power utilities.

The company prepares its cash flow statement using the indirect method as per Accounting Standard (AS) 3, ‘Cash Flow Statements’. While preparing the draft financial statements for the financial year 2008-09, according to the company being a financial institution, disclosed the net cash outflows/inflows from loan disbursements made to/principal repayments received from the borrowers under the head ‘cash flows from financing activities’

Discuss, Whether it is correct to classify the amounts of loans disbursed to and the repayments received from the borrowers under the head ‘cash flows from operating activities’, and the amounts of loans raised from and the repayments made to the lenders under the head ‘cash flows from financing activities’, as per the indirect method of preparation of cash flow statement as per AS 3?

#### **Audit Strategy Planning and Programming**

3. (a) Designing an Audit Strategy is the backbone of the “Audit Planning” process. Discuss.  
(b) Your firm is the auditor of HPCL Ltd. which operates 25 petrol stations in and around India. You are the senior in charge of the audit for the year ending 31<sup>st</sup> March, 20x9 and are engaged on the audit planning. Most of the company’s sites are long-established and, as well as supplying fuel, oil, air and water, have a car wash and a shop.

Over the last few years, due to the intense price competition in petrol retailing, the shops have been expanded into mini-markets with a wide range of motor accessories, food, drinks and household products. They also now sell National lottery tickets. Point-of-sale PCs are installed in all the petrol stations, linked on-line via a network to the computer at head office. Sales and inventory data are input direct from the PCs.

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The company has an internal auditor, whose principal function is to monitor continuously and test the operation of internal controls throughout the organization. The internal auditor is also responsible for coordinating the year end inventory count.

#### **Requirements**

Prepare notes for a planning meeting with the audit partner which

- (i) Identify, from the situation outlined above, circumstances particular to HPCL Ltd. that should be taken into account when planning the audit, explaining clearly why these matters should be taken into account.
- (ii) Describe the extent to which the work performed by the internal auditor may affect your planning, and the factors that could limit the use you may wish to make of his work.

#### **Risk Assessment and Internal Control**

4. You are the auditor of M Ltd, a distributor of automotive components, and have been provided with the following description of the sales order processing system.

##### **Order entry**

Sales orders are taken over the telephone and entered into the computer by a sales order clerk, via a terminal in the sales office, while the customer is on the line. On entry the order details are read back to the customer for confirmation. The computer checks that there are sufficient inventories to meet the order and that the customer's credit limit is not exceeded.

If the goods are unavailable, the customer is asked if he wants the order to be recorded as a 'back order' which will be fulfilled when there is sufficient inventory. Once accepted, the order is automatically given an order number which is relayed to the customer.

Orders which take a customer over his credit limit are referred to the credit controller who decides, in consultation with the chief accountants, whether or not the customer should be allowed to exceed the credit limit or have the credit limit raised. Any adjustments in respect of overrides of, or increase in, credit limits are input, via a terminal in the accounts department, by the credit controller. Printouts of these amendments are not generated and no other review of credit limits is undertaken.

New customers are referred to the credit controller who obtains credit ratings and references and, on the oral authority of the chief accountant, enters the customer account details onto the sales

##### **Despatch of goods**

Sequentially-numbered packing notes in respect of accepted orders are printed out in the warehouse, and the goods are selected, packed and checked by warehouse staff. Confirmations of packing and any notifications of shortfalls are entered into the computer, via a terminal in the warehouse, by the warehouse supervisor. Two copies of the sequentially numbered delivery advice are printed in the warehouse and sent with the

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goods to the customer who is required to sign a copy which is returned by the driver to the accounts department. All despatches are checked at the gatehouse to ensure that they are accompanied by the appropriate documentation. The packing notes are filed in numerical order in the warehouse and the sequence is checked for completeness, on a daily basis, by the warehouse supervisor.

The system does not automatically generate purchase orders with manufacturers when a customer's order cannot be fulfilled.

### **Computer system**

All users of the system are required to log on using identification codes and individual passwords which control their level of access to the system. All passwords are changed every 90 days and when employees leave. Systems support is provided by a supplier where the service agreement provides for availability of a back-up system within 72 hours of a systems failure.

### **Requirements**

- (a) Identify the objectives of exercising internal controls over sales order processing ignoring sales invoicing or ledger processing. For each objective discuss the extent to which the procedures exercised by M Ltd achieve the objective.
- (b) Set out, in a manner suitable for inclusion in a report to management, any weaknesses in the system described above. For each weakness you should include the possible consequence of the weakness and a recommendation to remedy the weakness.

### **Audit under CIS Environment**

- 5. (a) Briefly discuss the type of internal control required under computer based system?
- (b) "Computers affect the implementation of the internal controls". Discuss the problems arises in implementation of internal control in CIS Environment.

### **Special Audit Techniques**

- 6. (a) Indicate briefly the purposes for which the analytical procedures are applied by the auditor.
- (b) "The extent of reliance on analytical procedures depends on several factors" Explain in the light of SA 520.

### **The Company Audit**

- 7. Comment on the following as an auditor:
  - (a) Y Ltd. purchased an existing bottling unit. The method of charging depreciation on machinery of the acquired unit was different from that followed by the company in its other units. The company wants to continue to charge depreciation for the acquired unit, in the method followed earlier by them and which was too consistent with their own method.
  - (b) In the previous year "Y" Ltd. has made a provision of 10% of the contract value on an ongoing project. The actual loss on completion of the contract in the subsequent

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year was 11%. The management adjusted the difference in the previous year's account. .

- (c) Shyam Ltd. has a paid up capital of Rs. 40 crores divided into equity shares of Rs. 10 each as on 31.03.2008. During the financial year 2008-09 it has issued bonus shares in the ratio 1: 1. The net profit after tax for the years 31-03.2008 and 31.3.2009 is Rs. 20 crores and Rs. 30 crores respectively. The Earnings Per Share (EPS) disclosed in the financial statements for the above two years is Rs. 5.00 and Rs. 3.75 respectively. Is the disclosure correct?

#### **Liabilities of Auditors**

8. (a) Indicate the precise nature of auditor's liability in the following situation and support your views with authority, if any:

Certain weaknesses in the internal control procedure in the payment of wages in a large construction company were noticed by the statutory auditor who in turn brought the same to the knowledge of the Managing Director of the company. In the subsequent year huge defalcation came to the notice of the management. The origin of the same was traced to the earlier year. The management wants to sue the auditor for negligence and also plans to file a complaint with the Institute.

- (b) You are appointed as an auditor of RST Ltd. State what will be your liability to third parties in relation to issue of Prospectus.

#### **Audit Report**

9. ABC Company has defaulted in compliance of section 58AA of the Companies Act, 1956 with regard to public deposits. Discuss, what are the reporting requirements under the Companies (Auditor's report) Order, 2003 for ABC Company?

#### **Audit Committee and Corporate Governance**

10. Design a Performa of auditor certificate as per Clause 49 of the listing agreement.

#### **Audit of Consolidated Financial Statements**

11. What are the Responsibilities of the Auditor of the Consolidated Financial Statements?

#### **Audit of Banking Company**

12. (a) What are the principal enactments governing bank audit?  
(b) As a branch auditor of a nationalised bank, how would you verify the following?  
(1) Bills Purchased and Discounted  
(2) Third Party Guarantees  
(3) Provision for Non-performing assets

#### **Audit of General Insurance Company**

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13. "Verification of premium is of utmost importance to an auditor in the audit of General Insurance Company". What are the steps to be taken by an auditor while verifying the premium?

### **Audit of Co-operative Society**

14. "The general process of auditing and the process of audit of Co-operative Societies are same but there are some special features to be kept in mind while doing audit of co-operative societies. What are the special features of Co-operative Societies Audit?

### **Audit of Non Banking Financial Company**

15. Explain the classification of NBFCs. What are the special points in the audit of a Non-Banking Equipment Leasing Finance Company?

### **Audit under Fiscal Laws**

16. Write an audit programme for the audit of public trust under section 12A of the Income-tax Act, 1961?

### **Cost Audit**

17. (a) Explain briefly "True and Fair Cost of Production".  
(b) What are the advantages that accrue because of a Cost audit to the following:  
(1) To Management  
(2) To Society  
(3) To Shareholder  
(4) To Government

### **Environmental Audit**

18. What are the main areas dealt in respect of various industrial units for the Environmental Audit?

### **Audit of Public Sector Enterprises**

19. "Comprehensive audit involves assessing efficiency and effectiveness of public enterprises." Discuss what is Comprehensive Audit? Enlist some of the areas to be examined therein.

### **Management Audit**

20. A large manufacturing company is suffering from working capital crunch. You as a Management Auditor enlist and discuss the related areas to overcome the company's problem.

### **Investigation and Due Diligence**

21. S wants to join PQR Ltd, a partnership firm as 25% sharing partner. Advise X, what important steps he should take while conducting Investigation on behalf of S as an Incoming Partner?

### **Peer Review**

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22. Develop an illustrative check list of audit programme of a reviewee for the guidance of the reviewer under the Peer Review Process?

#### **The Sarbanes Oxley Act of 2002**

23. State briefly eight provisions of the Sarbanes-Oxley Act of 2002, which shall, if strictly applied to Indian Corporate, get fruitful results.

#### **Professional Ethics**

24. Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

- (a) The Cashier of a company committed a fraud and absconded with the proceeds thereof. This happened during the course of the accounting year. The Chief Accountant of the company also did not know about fraud.

In the course of the audit, at the end of the year, the auditor failed to discover the fraud. After the audit was completed, however, the fraud was discovered by the Chief Accountant. Investigation made at that time indicates that the auditor did not exercise proper skill and care and performed his work in a desultory and haphazard manner. With this background, the Directors of the company intend to file disciplinary proceedings against the auditor.

Discuss the position of the auditor with regard to the disciplinary proceedings.

- (b) XYZ Co. Ltd. has applied to a bank for loan facilities. The bank on studying the financial statements of the company notices that you are the auditor and requests you to call at the bank for a discussion. In the course of discussions, the bank asks for your opinion regarding the company and also asks for detailed information regarding a few items in the financial statements. The information is available in your working paper file. What should be your response and why?
- (c) BC & Co, a firm of Chartered Accountants, accepted an assignment for audit under State level VAT Act, without any prior communication with the previous auditor.
- (d) Q, a Chartered Accountant, failed to report to the shareholders of the Z Ltd, about the non-creation of a sinking fund in accordance with the Debenture Trust Deed and did not make clear that the amount shown as Sinking Funds, were borrowed from the Managing Agents of the Z Ltd.
- (e) M/s AVQ Ltd, a firm of Chartered Accountants responded to a tender from a State Government for computerization of property takings records. For this purpose, the firm also paid Rs.40, 000 as earnest deposit as part of the terms of the tender.
25. Write a short note on the following
- (a) Factors to consider in determining the use of Computer Assisted Audit Techniques (CAATs).
- (b) Reconciliation of cost and financial accounts.

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- (c) Audit vs. Investigation.
- (d) Facultative reinsurance under Insurance Act, 1938

### SUGGESTED ANSWERS/HINTS

1. (a) **Auditors responsibilities relating to the fraud in an audit of financial Statements** : The management's request that the amount defaulted by the Executive Director was deposited after the teeming and lading fraud was detected by the auditors and, therefore, no reporting is necessary is not tenable. It will be necessary for the auditor to bring to the notice of the shareholders about the teeming and lading fraud since the same had been committed by the Executive Director. Such an event shows that the internal control systems are quite weak in the organization and the top management is in a position to abuse its authority.

The mere fact that no loss to the company has occurred would not preclude the auditor from bringing it to the notice of the shareholders. A suitable disclosure is called for, particularly, in view of the fact that the fraud has been committed by the Executive Director. Even SA-240 (Revised) on Auditors responsibilities relating to the fraud in an audit of financial statements require specifically, if the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained.

#### **Conclusion:**

Thus, the auditor should also consider the implications of the circumstances on the true and fair view which the financial statements ought to convey and frame his report accordingly.

[**Note:** The question does not specify the amount of money involve. Therefore, it is difficult to apply the criterion of materiality. But, students would appreciate that smaller the amount involved, the more important it is necessary to disclose the same having regard to involvement of the top management]

- (b) **Auditor's assessment of materiality:** SA 320 on "Materiality in Planning and Performing an Audit" recommends that the concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. SA 450

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“Evaluation of Misstatements Identified during the Audit”, explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

While formulating an overall audit plan, SA 300(Revised) on “Planning an Audit of Financial Statement” also requires the auditor to consider the setting of materiality levels for audit purpose right from the initial stages. Accordingly, the auditor has to access the materiality aspect right from the initial stages. Accordingly, the auditor has to access the materiality aspect right from the initial stages of audit planning and throughout the process of conducting the audit till the audit opinions is formulated.

However, the auditor's assessment of materiality may be different at the time of initially planning the engagement than at the time of evaluating the results of his audit procedures. Since audit materiality related to specific amount balances and classes of transactions, helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to support the audit opinion at an acceptably low degree of audit risk. Such selection of audit procedures would undergo a change as audit work progress. The assessment of materiality and audit risk the stage of evaluating the results of audit procedures would also change because of a change in circumstances or a change in the auditor's knowledge as results of audit. For example, if the audit is planned prior to period end, the auditor will anticipate the results of operations and the financial position. If actual results of operations and financial position are substantially different, the assessment of materiality and audit risk may also change. Additionally the auditor may, in planning the audit work, intentionally set the acceptable cut-off level for verifying individual transactions at a lower level than is intended to be used to evaluate the results of the audit. This may be done to cover a larger number of items and thereby reduce the likelihood of undiscovered misstatements and to provide the auditor with the major of safety when evaluating the effect of misstatements discovered during the audit.

### **2. Facts :**

A Government of India undertaking, incorporated under the Companies Act, 1956 in the year 1987, is a dedicated financial institution mainly engaged in providing loans and other non-fund based products to various power utilities, classify the amounts of loans disbursed to and the repayments received from the borrowers under the head ‘cash flows from operating activities’, and the amounts of loans raised from and the repayments made to the lenders under the head ‘cash flows from financing activities’, as per the indirect method of preparation of cash flow statement as per AS 3

### **Provisions of AS – 3 Cash Flow Statements:**

Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of:



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- (a) changes during the period in inventories and operating receivables and payables;
- (b) non-cash items such as depreciation, provisions, deferred taxes, and unrealised foreign exchange gains and losses; and
- (c) all other items for which the cash effects are investing or financing cash flows.” .

For a financial institution the operating revenues (i.e. interest on loans, etc.) are generated from the loans disbursed, the loan disbursements made/repayments received from the borrowers should be classified as cash flows from the operating activities.

AS 3 also defines financing activities as “activities that result in changes in the size and composition of the owners’ capital (including preference share capital in the case of a company) and borrowings of the enterprise”.

Cash flows from loans raised and bonds issued and cash repayments of the amounts borrowed in case of all enterprises (financial or non-financial) have to be classified under ‘financing activities’ as the definition of ‘financing activities’ as per AS 3 does not make any distinction between financial and non-financial enterprises or between the funds raised for operating activities or investing activities. Accordingly, in case of a financial enterprise, even though the ‘loans raised and repayments made’ and ‘loan disbursements and repayments received’ are interdependent, the former cannot also be classified as ‘operating activity’ for the purposes of AS 3.

### Conclusion:

Thus, it is correct to classify the amounts of loans raised from and the repayments made to the lenders under the head ‘cash flows from financing activities’ and the amounts of loans disbursed to and the repayments received from the borrowers under the head ‘cash flows from operating activities’, as per the indirect method of preparation of cash flow statement as per AS-3. For the purpose of the preparation of cash flow statement, the aforesaid amounts would be arrived as increase/decrease in the borrowings and loans & advances outstanding in the two balance sheets relevant for the Cash Flow Statement.

3. (a) Audit strategy is concerned with designing optimised audit approaches, which seeks to achieve the necessary audit assurance at the lowest cost within the constraints of the information available. The formulation of audit strategy as shall be evident from the process as explained in the following paragraphs in fact shall form the basis of audit planning to achieve the audit objectives in the most efficient and effective manner. Audit strategy generally involves the following steps:
  - (i) **Obtaining Knowledge of Business:** SA 315 “Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment” and “The Auditor’s Responses to Assessed Risks” states that in performing an audit of financial statements, the auditor should have or obtain knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor’s judgement, may have a significant effect on the financial statements or on the examination or audit report. Knowledge of the business is a frame of

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reference within which the auditor exercises professional judgement. Understanding the business and using this information appropriately assists the auditor in assessing risks and identifying problems, planning and performing the audit effectively and efficiently. It also ensures that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to enable them to carry out the audit work delegated to them. This would also ensure that the audit staff understands the need to be alert for additional information and the need to share that information with the auditor and the other audit staff.

- (ii) **Performing Analytical Procedures:** The purpose of analytical procedures at the planning stage is attention-directing; corroboration is not normally necessary at this stage. The use of the analytical procedures during the planning stage requires the extensive use of accounting and business knowledge and experience to assess the potential for material misstatement in the financial statements as a whole, because the key aspect of the task is to identify the relevant risk indicators and to interpret them properly. Furthermore, analytical techniques applied during the planning stage are not generally as precise as the analytical techniques at the substantive stage.
- (iii) **Evaluating Inherent Risk:** To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors such as quality of accounting system, unusual pressure on management, etc. having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which, might have taken place since his last assessment.
- (iv) **Evaluating Internal Control:** The auditor's assessment of the control environment is crucial to the decision on whether to make an extended assessment of controls. This is because a good control environment is conducive to the maintenance of a reliable system of accounting and control procedures. For strategy purposes, the auditor should obtain a sufficient understanding of the control environment. The auditor needs an understanding of the accounting systems, regardless of whether the audit strategy will involve an extended assessment of internal accounting controls. This is done by:
  - (a) considering the results of gathering or updating information about the client; and
  - (b) making preliminary judgements about materiality, inherent risk and control effectiveness. These will include identification of the system(s) the auditor proposes to subject to an extended assessment of controls.

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Thus, the audit strategy is evolved after considering the engagement objectives, the results of the business review, preliminary judgements as to materiality and identified inherent risks. Audit strategy also considers main points relating to planning and controlling the audit or comments on adequacy of the existing arrangements. Thus, the overall audit plan involving determination of timing, manpower, coordination and the directions in which the audit work has to proceed is dependent upon the audit strategy formulated by the audit firm.

**(b) (i)**

| <b>Circumstances</b>   | <b>Why taken into account</b>   |
|--|---|
| ➤ Multiple business locations.   | ➤ Increases inherent risk (eg if the organisational structure is loose and difficult to manage).  |
| ➤ Intense price competition.   | ➤ May lead to uneconomic price discounting, possibly threatening viability of business.   |
| ➤ Recent expansion of outlets into minimarkets.                            | ➤ Increases complexity of business and may lead to loss of management control.  |
| ➤ Perishable nature and limited shelf-life of food and drinks inventories. | ➤ Increase risk of overstatement of inventory values.   |
| ➤ Large volume of cash transactions.                                       | ➤ Increases risk of incomplete income recording.  |
| ➤ Nature of the business (garage environment).                             | ➤ Increases risk of loss of inventories and cash due to theft or staff pilferage.<br>➤ May limit effectiveness of physical security controls (eg over access to terminals). |
| ➤ Recent introduction of sales of National Lottery tickets.                | ➤ Increases inherent risk (eg the risk of loss to HPCL Ltd. if incorrect amounts are paid out on winning tickets).  |
| ➤ Direct input via PCs at branches.  | ➤ Increases risk of misstatement, as batch controls will not be feasible and scope for other input controls may be limited.   |
| ➤ Small number of staff at each location (eg one or two).                  | ➤ Limits scope for segregation of duties within branches and therefore increases control risk.  |

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| ➤ Branch-based nature of business.                | ➤ Limits effectiveness of management control over activities of individual branches thereby increasing control risk. |
| ➤ Use of part-time staff and high staff turnover. | ➤ May inhibit effectiveness of controls within branches.   |

#### (ii) Effect of work of internal auditor on audit planning

- The internal auditor's identification and documentation of areas of weakness will give direction to areas requiring increased substantive procedures.
- Work of the internal auditor may assist in selection of branches for audit visits, (e.g. where control failures have occurred).
- The internal auditor may attend year end inventory counts at one or more branches, potentially reducing the number of branches to be visited by us.
- Work performed by the internal auditor may provide evidence to confirm operation of control procedures, on which we may seek to rely to reduce the extent of our own procedures.
- Documentation of systems and controls by the internal auditor, including changes due to the National Lottery, may reduce extent of our planning visits, as walk through checks may be sufficient to confirm systems documentation.

#### 4. (a) Internal controls over sales order processing

| Objectives  | Extent to which achieved by M Ltd's procedures   |
|---|--|
| ➤ To ensure that goods are available for all orders accepted.   | <ul style="list-style-type: none"> <li>➤ The availability of inventories is checked on the computer system while the customer is on the line.</li> <li>➤ This will be effective only where the system is continuously updated for new orders and deliveries of inventories.</li> </ul> |
| ➤ To ensure that existing customers are within their credit limits (including the current order being taken). | <ul style="list-style-type: none"> <li>➤ The computer system automatically checks that the customer is within his current credit limit.</li> <li>➤ Adjustments to credit limits are carried out by the credit controller but no review of any amendments is carried out.</li> </ul>    |

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| ➤ To ensure that new customers are creditworthy before orders are despatched.   | ➤ The credit controller carries out credit checks but details are amended on the terminal in the accounts department only after oral authority from the chief accountant, and no subsequent review of new customers is performed.   |
| ➤ To ensure that changes to credit limits are valid.                            | ➤ As above.   |
| ➤ To ensure that the correct goods are despatched to each customer.             | ➤ Order details are read back to the customer to confirm their accuracy.<br>➤ Packing notes are produced in the warehouse giving the details of the order. However, there is no responsibility assigned in respect of dealing with shortfalls of inventories and ensuring that the customer ultimately receives all of the goods ordered. |
| ➤ to ensure that goods are despatched for all orders accepted                   | ➤ Packing notes are sequentially numbered and a completeness check is carried out on a daily basis.   |
| ➤ To ensure that all goods leaving the premises are in respect of valid orders. | ➤ All goods leaving the warehouse are checked at the gatehouse to ensure that they are accompanied by a valid delivery advice.  |
| ➤ To ensure that back orders are fulfilled when inventories become available.   | ➤ There are no procedures in place to ensure that, one goods are received by M Ltd, back orders are fulfilled.  |

**(b) Points for inclusion in a report to management**

| <b>Weakness</b>   | <b>Consequence</b>  | <b>Recommendation</b>  |
|---|---|--|
| ➤ There is no review of amendments to credit limits once these have been processed on the system. | ➤ Invalid amendments could be made, leading to supply of goods to non-creditworthy customers. | ➤ An exception report should be produced on a weekly basis detailing all changes made to credit limits. This should be reviewed by the chief accountant, and |

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|   |   | evidenced by his signature, to ensure that all amendments are for valid business reasons.  |
| ➤ Authority to enter new customers onto the system is only given orally with no review of the credit ratings and references obtained. | ➤ Invalid entries of new customers could be made without detection until non-payment of invoices arises.                                      | ➤ The chief accountant should review the credit ratings and references obtained before giving authority to accept the new customer.  |
| ➤ There is no responsibility assigned for dealing with shortfalls in orders when they are being selected in the warehouse.            | ➤ Delivery of part-complete orders and non-delivery of parts of orders will lead to loss of customer goodwill and subsequent loss of revenue. | ➤ A daily printout of unprocessed orders should be produced and followed up by the warehouse supervisor.   |
| ➤ There are no procedures to ensure that back orders are fulfilled when the goods become available.                                   | ➤ Delay in fulfilling customer orders will again lead to loss of customer goodwill.   | ➤ The system should produce a daily list of items that have come into inventory for which there are current back orders. The sales ledger clerk should contact the customer to ensure that the goods are still required and then process the order in the normal manner. |
| ➤ When back orders are accepted the goods which are unavailable are not immediately reordered.  | ➤ There may be significant delays in fulfilling these orders.   | ➤ The computer should automatically generate purchase requisitions on a daily basis for items which have been requested but are unavailable. A   |

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|--|--|--|
|  |  | supervisor should review these purchase requisitions and raise a purchase order where the goods have not already been ordered. |
|--|--|--|

**Additional notes:**

- Credit control procedures do not take the age of the debt into consideration; this could result in goods being despatched to slow payers.
  - In respect of the failure to review credit limits on a regular basis, limits may be unrealistically low for customers with a good payment history, resulting in loss of business.
  - Response time in respect of systems support is too slow; this could result in delayed and lost orders.
5. (a) The requirement of internal control under Computer based system may cover the following aspects:
- (i) **Organisation and Management Control** – Controls are designed to establish an organisational frame work for CIS activities including:
    - (a) Policies and procedures relating to control functions.
    - (b) Appropriate segregation of incompatible functions.
  - (ii) **Application System Development and Maintenance Control** – Controls are designed to provide reasonable assurance that systems are developed and maintained in an authorised and efficient manner, to establish control over:
    - (a) testing, conversion, implementation and documentation of new revised system.
    - (b) changes made to application system.
    - (c) access to system documentation.
    - (d) acquisition of application system from third parties.
  - (iii) **Computer Operation Controls** – Designed to control the operation of the system and to provide reasonable assurance that:
    - (a) the systems are used for authorised purposes only.
    - (b) access to computer operation is restricted to authorised personnel.
    - (c) only authorised programs are to be used.
    - (d) processing errors are detected and corrected.
  - (iv) **System Software Control** – Controls are designed to provide reasonable assurance that system software is acquired or developed in an authorised and efficient manner including:

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- (a) authorisation, approval, testing, implementation and documentation of new system software and system software modification.
- (b) restriction of access to system software and documentation to authorised personnel.
- (v) **Data Entry and Program Control** – Designed to provide assurance:
  - (a) an authorisation structure is established over transaction being entered into the system.
  - (b) access to data and program is restricted to authorised personnel.
- (vi) **Control over Input** – Controls are designed to provide reasonable assurance that:
  - (a) transactions are properly authorised before being processed by the computer.
  - (b) transactions are accurately converted into machine readable form and recorded in the computer data files.
  - (c) transactions are not lost, added, duplicated or improperly changed.
  - (d) incorrect transactions are rejected, corrected and if necessary, resubmitted on a timely basis.
- (vii) **Control Over Processing and Computer Data Files** - Controls are designed to provide reasonable assurance that:
  - (a) transactions including system generated transactions are properly processed by the computer.
  - (b) transactions are not lost, added duplicated or improperly changed.
  - (c) processing errors are identified and corrected on a timely basis.
- (viii) **Control Over Output** - Designed to provide reasonable assurance that
  - (a) results of processing are accurate.
  - (b) access to output is restricted to authorised personnel.
  - (c) output is provided to appropriate authorised personnel on a timely basis.
- (ix) **Other Safeguards** - Other safeguards include:
  - (a) Offsite back-up of data and program.
  - (b) Recovery procedures for use in the event of theft, loss or intentional or accidental destruction.
  - (c) Provision of offsite processing in the event of disaster.
- (b) Internal control system include separation of duties, delegation of authority and responsibility, a system of authorisation, adequate documents and records, physical control over assets and records, management supervision, independent checks on performance and periodic reconciliation of assets with records. In computer based



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system, all these components must exist but computers affects the implementation of these internal controls in many ways. Some of the effects are as under:

- (i) **Separation of Duties** – In a manual system, different persons are responsible for carrying out function like initiating, recording of transaction, safeguarding of assets, does not always apply in a computer system. For example, in a computer system, a program may carryout reconciliation of vendor invoice against a receipt document and also prepares a cheque payable to creditors. Such operation through a program will be considered as incompatible functions in a manual system.

In minicomputer and microcomputer environments, separation of incompatible function could be even more difficult. Some such forms, allows, users to change programs and data entry without providing a record of these changes. Thus, it becomes difficult to determine whether incompatible function have been performed by system users.

- (ii) **Delegation of Authority and Responsibility** - A structured authority and responsibility is an essential control within manual and computer environment. In a computer system however, a clean line of authority and responsibility might be difficult to establish because some resources are shared among multiple users. For instance, one objective of using a data base management system is to provide multiple users with access to the same data, thereby reducing the control problems that arise with maintaining redundant data, when multiple users have access to the same data and the integrity of the data is somehow violated, it is not always easy to trace who is responsible for corrupting the data and who is responsible for identifying and correcting the error. Some organisation identified a single user as the owner of the data.
- (iii) **Competent and Trustworthy Personnel** - Skilled, competent, well-trained and experienced in formation system personnel have been in short supply. Since substantial power is often vested in the person responsible for the computer information system development, implementation, operation and maintenance within the organisation, competent and trustworthy personnel is very much in demand. Unfortunately, the non availability of competent personnel, forced many organisation to compromise on their choice of staff. Moreover, it is not always easy for organisation to assess the competence and integrity of their system staff. High turnover among those staff has been the norm. Some information systems personnel lack a well developed sense of ethics and some enjoy in subverting controls.
- (iv) **System of Authorisation** - Management authorisation of transaction may be either:
  - (a) general authorisation to establish policies for the organisation,
  - (b) specific authorisation applying to individual transactions. In manual system, auditors evaluate the adequacy of procedures for authorisation

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by examining the work of employees. In a computer system, authorisation procedures often are embedded within a computer program. In a computer system, it is also more difficult to assess whether the authority assigned to individual persons is constant with managements policies. Thus, in evaluating the adequacy of authorisation procedures, auditors have to examine not only the work of employees but also the veracity of the programme processing.

- (v) **Adequate Documents and Records** – In a manual system, adequate documents and records are required to provide an audit trail of activities within the system. In computer system, document support might not be necessary to initiate, execute and records some transaction. The task of a visible audit trail is not a problem for auditors; provided the systems have been designed to maintain a record of all events and that they are easily accessible. In well-designed computer systems, audit trails are more extensive than those maintained in manual systems unfortunately not all computer systems are well designed. This creates a serious control problem.
- (vi) **Physical Control over Assets and Records** – Physical access to assets and records is critical in both manual systems and computer system. In a computer system the information system assets and records may be concentrated at a single site. The concentration of information systems assets and record also increases the losses that can arise from computer abuse or disaster. If the organisation does not have another suitable backup, it might be unable to continue operations.
- (vii) **Adequate Management Supervision** – In a computer system, supervision of employee might have to be carried out remotely. Supervisory controls must be built into the computer system to compensate for the controls that usually can be exercised through observation and in inquiring computer system also make the activities of employees less visible to management. Because many activities are electronically controlled managers must periodically access the audit trial of employee activities and examine it for unauthorised actions.
- (viii) **Independent Checks On Performance** – Checks by an independent person help to detect any errors or irregularities. In a computer system, if a program code is authorised accurate, and complete the system will always follow the laid down procedures in absence of other type of failures like hardware or systems software failure. Thus, independent checks on the performance of programs often have little value. Instead, the control emphasis shifts to ensuring the veracity of programme code. Auditors must now evaluate the controls established for program development, modification operation and maintenance.
- (ix) **Comparing Recorded Accountability with Assets** – In a manual system, independent staff prepares the basic data used for comparison purposes. In a computer system software is used to prepare this data. If unauthorised

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modifications occur to the program or the data files that the program uses, an irregularity might not be discovered, because traditional separation of duties no longer applies to the data being prepared for comparison purposes.

### **6. (a) Analytical Procedures :**

Analytical procedures” means the analysis of significant ratios and trends, including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.

#### **Purpose of use of Analytical Procedures**

Analytical procedures are used for the following purposes:

- (a) to assist the auditor in planning the nature, timing and extent of other audit procedures;
- (b) as substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions; and
- (c) as an overall review of the financial statements in the final review stage of the audit.

Thus analytical procedures may be used extensively while conducting an audit to establish authenticity of information contained in the financial statements. In some cases, analytical procedures can be more effective than tests of details in reducing the detection risk for specific financial statement assertions. This is particularly true in case volume of information is homogeneous and quite large. For example, in case of salaries and wages the volume is generally quite large and only internal evidence is available. In such a case performing analytical procedure would provide substantive audit evidence and reduce the extent of vouching to a large extent.

### **(b) The extent of reliance on analytical procedures depends on several factors:**

As per SA 520 “Analytical Procedures”, The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as the completeness, accuracy and validity of the data produced by the accounting system. However, reliance on the results of analytical procedures will depend on the auditor’s assessment of the risk that the analytical procedures depend on the following factors:

- (a) Materiality of the items involved, for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material;
- (b) Other audit procedures directed toward the same audit objectives, for example, other procedures performed by the auditor in reviewing the collectability of accounts receivable, such as the review of subsequent cash receipts, might

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confirm or dispel questions raised from the application of analytical procedures to an ageing schedule of customers' accounts;

- (c) Accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising; and
- (d) Assessments of inherent and control risks, for example, if internal control over sales order processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.

Finally, the auditor will need to consider testing the controls, if any, over the preparation information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The controls over non-financial information can often be tested in conjunction with tests of accounting –related controls. For example, an entity in establishing controls over the processing of sales invoices may include controls over the recording of unit sales. In these circumstances, the auditor could test the controls over recording of unit sales in conjunction with tests of the controls over the processing of sales invoices.

- 7. (a) Guidance Note on Accounting for Depreciation in companies issued by the Institute recommends that a company may adopt more than one method of depreciation. Therefore, it is permissible to adopt or follow different methods of depreciation, for different types of assets, provided the same methods are consistently adopted every year in terms of section 205(2) of the Companies Act, 1956. Also units in different geographical locations can follow different methods of depreciation on machinery provided the same are consistently followed. Therefore, Y Ltd. could continue to follow the previous method of charging depreciation for the acquired company, even if it is not in agreement with the method followed by Y Ltd. for their other units.
- (b) The provision of loss of 10% of the contract value by Y Ltd. in previous year is in the nature of accounting estimate since due to uncertainties inherent in any business activity; it is difficult to measure such item in a precise manner. Accordingly, adjusting the difference in the previous years' account is not correct. AS-5 on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, states that the effect of a change in an accounting estimate should be included in determination of net profit or loss in the period of the change, if the change affects the period only. Thus, the management should adjust the difference in the current period only. Alternatively, the auditor should qualify his report.
- (c) **Disclosure of Earnings Per Share:** AS 20 on Earning Per Share (EPS) prescribes principles for the determination and presentation of EPS. As per AS 20, the earnings per share have to be disclosed as basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a

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different right to share in the net profit for the period. In the instant case, Shyam Ltd., both the basic as well as the diluted earnings per share would be the same since there are no dilutive instruments that have been issued by the company. As per AS 20, in the case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration and thus would lead to increase in number of equity shares without any adjustment to outstanding capital amount. Therefore, the number of equity shares outstanding is increased without an increase in resources. The standard further requires that the number of equity shares outstanding before the event of a bonus issue to be adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. Hence the EPS calculated as on

31-03-2008 would be adjusted EPS and the same would be disclosed. In view of the above, the EPS will be calculated as under:

|                  |                        |                |
|------------------|------------------------|----------------|
| As on 31.03.2008 | Profits                |                |
|                  | Adjusted No. of Shares | = Adjusted EPS |
|                  | 20,00,00,000           |                |
|                  | 8,00,00,000            | = Rs. 2.5      |
| As on 31.03.2009 | Profits                |                |
|                  | No. of Shares          | = EPS          |
|                  | 30,00,00,000           |                |
|                  | 8,00,00,000            | = Rs. 3.75     |

Since the above figures of EPS have not been disclosed, Shyam Ltd. has not complied with the provisions of AS 20. Therefore, the auditor would have to qualify his report in terms of section 227(3)(d) of the Companies Act, 1956.

8. (a) In the given case, certain weaknesses in the internal control procedure in the payment of wages in a large construction company were noticed by the statutory auditor and brought the same to the knowledge of the Managing Director of the company. In the subsequent year, a huge defalcation took place, the ramification of which stretched to the earlier year. The management of the company desires to sue the statutory auditor for negligence. The precise nature of auditor's liability in the case can be ascertained on the basis of the under noted considerations:
- (i) Whether the defalcation emanated from the weaknesses noticed by the statutory auditor, the information regarding which was passed on to the management; and
  - (ii) Whether the statutory auditor properly and adequately extended the audit programme of the previous year having regard to the weaknesses noticed.

SA 265 on "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management" clearly mentions that, "The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit

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work performed, whether, individually or in combination, they constitute significant deficiencies. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis". The fact, however, remains that, weaknesses in the design of the internal control system and non-compliance with identified control procedures increase the risk of fraud or error. If circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate. Thus, normally speaking, as long as the auditor took due care in performing the audit work, he cannot be held liable.

The fact that the matter was brought to the notice of the managing director may be a good defence for the auditor as well. According to the judgement of the classic case *In re Kingston Cotton Mills Ltd.*, (1896) it is the duty of the auditor to probe into the depth only when his suspicion is aroused. The statutory auditor, by bringing the weakness to the notice of the managing director had alerted the management which is judicially held to be primarily responsible for protection of the assets of the company and can put forth this as defence against any claim arising subsequent to passing of the information to the management. In a similar case *S.P. Catterson & Sons Ltd.* (81 Acct. L. R.68), the auditor was acquitted of the charge.

- (b) Section 62 of the Companies Act, 1956 lays down the civil liability for misstatement in a prospectus issued to invite persons to subscribe for shares in or debentures of a company. The professional accountant will in such a case be liable to pay compensation to every person who subscribes for any shares or debentures on the faith of the prospectus for any loss or damage sustained because of an untrue statement made by him as an expert.

However, professional accountants will not be liable if they can prove that:

- (i) the prospectus was issued without his knowledge or consent and that on becoming aware of its issue he forthwith gave reasonable public notice that it was issued without his knowledge or consent; or
- (ii) he withdrew his consent in writing before delivery of the prospectus for registration; or
- (iii) after the delivery of prospectus for registration but before allotment of shares, on becoming aware of the untrue statement, he withdrew his consent in writing and gave reasonable public notice of the withdrawal, and of the reasons therefore; or
- (iv) he was competent to make the statement and that he had reasonable grounds to believe and did up to the time of allotment of the shares or debentures believe that the statement was true.

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9. Under paragraph 4(VI) of Companies (Auditor's) Report Order, 2003 as amended by Companies (Auditor's) Report (Amendment) Order, 2004, the audit report should include following matters:

In case company has accepted any deposits from public whether directives issued by the Reserve Bank of India and the provisions of sections 58 A and 58 AA or any other relevant provisions of the Act and the rules framed there under, where ever applicable, have been complied with. If not the nature of contraventions should be stated. If an order has been passed by Company Law Board or National Law Tribunal or Reserve Bank of India or any court or any other tribunal whether the same has been complied with or not ?

Section 58 AA deals with small depositors. As per this, a small depositor means a depositor who has deposited during a financial year a sum not exceeding rupees twenty thousand this section requires compliance of certain matters by the company.

Non compliance of section 58 AA occurs where company fails to intimate company law board, any default in repayment of deposit by small depositors or part there of or any interest thereupon. The auditor has therefore, to first determine whether there is any default in repayment of such deposits, when number of depositors are large, it may not be possible for an auditor to verify each repayment. In such situation, he should examine internal control system. He should obtain schedule of repayment to small depositors, and should make reasonable test checks of repayments made by the company. If during test check, default in repayment is noticed, he should see whether the same has been intimated to Company Law Board.

Over and above this, auditor should also examine regarding non compliance of section 58 AA or rules made there under he should enquire, about any order passed by Company Law Board for contravention of section 58 AA

The auditor should obtain management representation to the effect whether:

- (a) Company has complied with directives issued by Reserve Bank of India and provision of section 58 AA or relevant rules.
  - (b) Where an order has been passed by Company Law Board, the company has complied with requirements of the order
10. A Performa of the Certificate to be issued by the Auditors regarding compliance of conditions of Corporate Governance is shown below:

**CERTIFICATE**

To,

The Members of.....

(Name of the entity)

We have examined the compliance of conditions of Corporate Governance by ( name of the entity ) for the year ended on ..... as stipulated in clause 49 of the listing Agreement of the said with stock Exchange (s).

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The compliance of conditions of Corporate Governance is the responsibility of the management. Our examination was limited to procedures and implementation thereof, adopted by the company for ensuring the compliance of the conditions of the Corporate Governance. It is neither an audit nor an expression of opinion on the financial statement of the company.

In our opinion, and to the best of our information and according to the explanations given to us, subject to the following:

(1)

(2)

We certify that the company has complied with the conditions of Corporate Governance as stipulated in the above mentioned listing Agreement.

We state that no / ..... investor grievance(s) is / are pending for a period exceeding one month against the company as per the records maintained by the shareholders / investors Grievance Committee.

We further state that such compliance is neither an assurance as to the future viability of the company nor the efficiency or effectiveness with which the management has conducted the affairs of the company.

For & on behalf of

XYZ & Co.

Chartered Accountants

(Partner / Proprietor)

Place.....

Date.....

11. The auditor of the consolidated financial statements is responsible for expressing an opinion on whether the consolidated financial statements are prepared, in all material respects, in accordance with the financial reporting framework under which the parent prepares the consolidated financial statements.

Therefore, the auditor's objectives in an audit of consolidated financial statements are:

- (a) to satisfy himself that the consolidated financial statements have been prepared in accordance with the requirements of Accounting Standard (AS) 21, Consolidated Financial Statements, Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements and Accounting Standard (AS) 27, Financial Reporting of Interests in Joint Ventures; and
- (b) to enable himself to express an opinion on the true and fair view presented by the consolidated financial statements.

Standards on Auditing, Statements and Guidance Notes on auditing matters issued by the Institute of Chartered Accountants of India apply in the same manner to audit of



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consolidated financial statements as they apply to audit of separate financial statements. It means that the auditors, while conducting the audit of consolidated financial statements are, inter alia, expected to:

- (a) plan their work to enable them to conduct an effective audit in an efficient and timely manner;
  - (b) obtain an understanding of the accounting and internal control systems sufficient to plan the audit and determine the nature, timing and extent of his audit procedures. Such an understanding would help the auditors to develop an effective audit approach;
  - (c) use professional judgement to assess audit risk and to design audit procedures to ensure that the risk is reduced to an acceptable level; etc.
12. (a) There is an elaborate framework governing the functioning of banks in India. The whole of banking sector can be categorised into several sectors such as commercial banks, co-operative banks, foreign banks, etc. The principal enactments which govern the functioning of various types of bank are as under:

- ◆ Banking Regulation Act, 1949
- ◆ State Bank of India Act, 1955
- ◆ Companies Act, 1956
- ◆ State Bank of India (Subsidiary Banks) Act, 1959
- ◆ Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970
- ◆ Regional Rural Banks Act, 1976
- ◆ Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980
- ◆ Information Technology Act, 2000
- ◆ Prevention of Money Laundering Act, 2002
- ◆ Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
- ◆ Credit Information Companies Regulation Act, 2005
- ◆ Payment and Settlement Systems Act, 2007

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

**(b) (1) Verification of Bills Purchased and Discounted**

- (a) The auditor should familiarise himself with the guidelines issued by the RBI and the policies framed by the bank itself regarding the discounting and rediscounting of bills. The auditor should ascertain that the policy framed by the bank conforms to the requirements laid down by the RBI.

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- (b) Bills purchased and discounted have to be shown separately in the balance sheet as a part of 'advances'. Further, under the head 'advances outside India' in the balance sheet, bills purchased and discounted outside India have to be shown separately. This category will include bills covering export of goods, bills discounted by foreign branches of the bank and payable in their respective countries, etc.
- (c) Banks purchase or discount bills of exchange drawn or endorsed by their customers. The bank credits the amount of the bill to its customer after deducting the discount. The total amount of such bills is shown as an asset in the balance sheet.
- (d) In certain eligible cases, the bills purchased or discounted by the bank may be rediscounted by it with the RBI IDBI/SIDBI. Such bills would not be included under advance but would constitute a contingent liability.
- (e) Bills purchased and discounted by the bank are generally drawn on outstation parties and are, therefore, sent by the bank to its branches or agents for collection immediately after their receipt. They are generally not in the possession of the bank on the closing date. The auditor therefore has to rely upon the Register of Bills Purchased and Discounted and the party-wise Register of Bills maintained by the bank. The auditor should examine these registers and satisfy himself that:
  - (i) all the outstanding bills have been taken in the balance sheet;
  - (ii) all the details, including the nature of the bills and documents are mentioned in the register and that the bills have been correctly classified;
  - (iii) the bills purchased or discounted from different parties are in accordance with the agreements with them and the total of outstanding bills of each party is not in excess of the sanctioned limit; and
  - (iv) the bills are not overdue. If there are any overdue bills, the auditors should ascertain the reasons for the delay and the action taken by the bank.
- (f) The auditor should examine whether registers of bills purchased and discounted are properly maintained and the transactions are recorded therein correctly.
- (g) Auditor should also examine whether the bills and the documents accompanying the bills are properly endorsed and assigned in favour of the bank. In checking the bills, it should be ensured that the bills are held along with the documents of title. In the case of documentary bills, it should be ensured that the related RRs/TRs are held along with the invoices/ hundies / bills and that these have not been parted with.

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Wherever such RRs/TRs are not held on record, the fact should be duly considered by the auditor.

The auditor should also examine bills collected subsequent to the year-end to obtain assurance regarding completeness and validity of the recorded bill amounts

### **(2) Verification of Third Party Guarantees**

- (a) The auditor should examine the guarantee bonds and the demand promissory notes in order to verify the third party liability.
- (b) The auditor should also satisfy himself that the guarantee is in force as at the date of the balance sheet.
- (c) In the absence of a provision to the contrary, a guarantee terminates by revocation or upon death of the surety. The surety is also discharged (unless there is a specific covenant to the contrary) if the creditor arranges with the principal debtor for composition, or agrees to give time or agrees not to sue him, without consulting the surety.
- (d) If any variation is made in the terms of the contract between the principal debtor and the creditor without the surety's consent, it discharges the surety as to transactions subsequent to the variation.
- (e) The guarantee forms used by banks normally seek to ensure the continuing obligation of the guarantor in spite of these contingencies.

### **(3) Verification of Provision for Non-performing assets**

- (a) An important aspect of audit of advances relates to their classification and provisioning. This implies that a proper provision should be made in respect of advances where the recovery is doubtful. Reserve Bank has prescribed objective norms for determining the quantum of provisions required in respect of advances. The auditors must take / download the latest Master Circular of RBI to familiarise himself fully with the norms prescribed by RBI in this regard. The circulars issued by RBI after the date of issue of Master Circular and till the date of audit should also be taken / downloaded and reviewed by the auditors for its adherence. However, these norms should be construed as laying down the minimum provisioning requirements and wherever a higher provision is warranted in the context of the threats to recovery, such higher provision should be made.
- (b) The accounting entry for provision in respect of debts that are doubtful of recovery is usually made at the head office level and is not recorded in the books at the branch level. The amount of provision to be made at the head office level is based largely on the classification of various advances into standard, sub-standard, doubtful and loss categories.
- (c) The auditor should carefully examine whether the classification made by

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the branch is appropriate. In doing so, he should particularly examine the classification of advances where there are threats to recovery.

- (d) The auditor should also examine whether the secured and the unsecured portions of advances have been segregated correctly and provisions have been calculated properly.
- (e) As per the Reserve Bank guidelines, if an account has been regularised before the balance sheet date by payment of overdue amount through genuine sources, the account need not be treated as NPA. Where, subsequent to repayment by the borrower (which makes the account regular), the branch has provided further funds to the borrower (including by way of subscription to its debentures or in other accounts of the borrower), the auditor should carefully assess whether the repayment was out of genuine sources or not. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory evidence to the Statutory Auditors about the manner of regularisation of the account to eliminate doubts on their performing status.

It is to be ensured that the classification is made as per the position as on date and hence classification of all standard accounts be reviewed as on balance sheet date. The date of NPA is of significant importance to determine the classification and hence specific care be taken in this regard.

**13. Verification of Premiums** - Verification of premium is of utmost importance to an auditor. So while verifying the same, the role of an auditor is also utmost important.

The auditor has to apply, inter alia, the following procedures for verification of premium -

- I. Before commencing verification of premium income, the auditor should look into the internal controls and compliance thereof as laid down for collection and recording of the premiums.
- II. The auditor should ascertain that all the cover notes relating to the risks assumed have been serially numbered for each class of business. The auditor should also verify that there is an adequate internal check on the issue of stationery comprising of cover notes, policy documents, stamps, etc. The auditor may apply sampling techniques for verification of larger volume of transactions.
- III. The auditor should ensure that premium in respect of risks incepting during the relevant accounting year has been accounted as premium income of that year on the basis of premium revenue recognition discussed in this Chapter. The auditor, as part of his audit procedures, should make an assessment of the reasonability of the risk pattern established by the management. The auditor should also see whether the premium received during the year but pertaining to risk commencing in

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the following year has been accounted for under the head 'Premium Received in Advance' and has been disclosed separately. Normally, such instances relate to the issue of cover notes and certificates at the end of the accounting year relating to risks commencing in the next accounting period. Generally, there is a column in the Premium Register called "Commencement of Risk", indicating the date and time from which the risk under the policy issued has commenced. The auditor should verify that policy documents have not been issued, or where issued, the company was not at risk, in case:

- (a) premium had not been collected at all;
  - (b) premium had been collected but the relevant cheques have been dishonoured; (refer Cheque Dishonoured Book);
  - (c) premium had not immediately been collected due to furnishing of a bank guarantee or cash deposit but either the deposit or guarantee had fallen short or has expired or the premium had been collected beyond the stipulated time limit (i.e., there is a shortfall in bank guarantee account or cash deposit account of the insured);
  - (d) premium had not been collected due to risk cover being increased or where stipulated limits have been exhausted in respect of open declaration policies (i.e., where premium has accrued but has not been received); and
  - (e) instalments of premium have not been collected in time in respect of certain categories of policies, e.g., marine-cum-erection policies where facility has been granted for premium being paid in instalments (such facility is normally available subject to certain conditions, e.g., that the first equated instalment is more by 5 per cent of the total premium payable by instalments).
- IV The auditor should examine whether the reinsurance company is not under a risk in respect of amount lying at credit and outstanding as at the year-end in the following accounts:
- (a) Deposit Premium Account;
  - (b) Premium Received in Advance Account;
  - (c) Inspectors' Deposits Account; and
  - (d) Agent's Premium Accounts
- V. The auditor should verify the collections lodged by 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, i.e., without providing for unexpired risks and reinsurances.
- VI. In case of co-insurance business, where the company is not the leader, because of the non-availability of the relevant information in many cases the premium is not booked even though the risk has commenced during the relevant accounting year. The auditor should see that the company's share of the premium has been accounted for on the basis of the available information on nature of risk and the

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provisional premium charged by the leading insurer. The auditor should examine the communications issued to the company by the leading insurers advising them of the company's share of premium income. Such communications should be seen even in respect of the post-audit period. Where the company is the leader, the auditor should obtain a reasonable assurance that only the company's own share of premium has been shown as income and accounts of the other companies have been credited with their share of the premium collected.

- VII. The auditor should check whether Premium Registers have been maintained chronologically, for each underwriting department, giving full particulars including service tax charged as per acceptance advice on a day-to-day basis. The auditor should verify whether the figures of premium mentioned in the register tally with those in General Ledger.
- VIII. Where policies have been issued with a provision to collect premium periodically (i.e., under instalment clause, special declaration policy or periodical declaration under open policies in marine insurance), the auditor should check whether premia are collected as and when they become due.
- IX. The auditor should verify whether instalments falling due on or before the balance sheet date, whether received or not, have been accounted for as premium income as for the year under audit. Also examine whether instalments of premium falling due in the subsequent year have not been recognised in the accounts as outstanding premium.
- X. The auditor should verify the year end transactions to check that amounts received during the year in respect of risks commencing/ instalments falling due on or after the first day of next financial year are not credited to premium account but credited to Premium Received in Advance Account.
- XI. The auditor should verify the collections remitted by agents immediately after the cut-off date to verify the risk assumed during the year under audit on those collections.
- XII. The auditor should also check that in case of cancellation of policies/cover notes issued, no risk has been assumed between the date of issue and subsequent cancellation thereof.
- XII. Where premium originally received has been refunded, the auditor should verify whether the agency commission paid on such premium has been recovered.
- XIV. The auditor should verify whether service tax has been charged from the insured, at the rates in force, on the total premium for all classes of business other than those exempted under service tax laws. Check whether service tax so collected is disclosed under 'Current Liabilities' to the extent not deposited in Government's Account.
- XV. In the case of co-insurance business, the auditor should verify whether service tax at the rates in force on the whole premium has been charged or collected from the insured by the company in case it is the leader.

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Check that service tax so collected on premium charged trained from the insured by the company have been regularly deposited in the Government's Account.

### 14. Special features of Co-operative Societies Audit

The general processes of auditing involved in audit work such as checking of posting, ascertainment of arithmetical accuracy, vouching, verification of assets and liabilities and final scrutiny of Balance Sheet are well known to the students, and the same are to be applied in co-operative audit as well. It need not be discussed in detail. However, the special features of co-operative audit, to be borne in mind in general while conducting the audit are as follows:

- i. **Examination of overdue debts** – Overdue debts for a period from six months to five years and more than five years will have to be classified and shall have to be reported by an auditor. Overdue debts have far reaching consequences on the working of a credit society. It affects its working capital position. A further analysis of these overdue debts from the viewpoint of chances of recovery will have to be made, and they will have to be classified as good or bad. The auditor will have to ascertain whether proper provisions for doubtful debts are made and whether the same is satisfactory. The percentage of overdue debts to the working capital and loans advanced will have to be compared with last year, so as to see whether the trend is increasing or decreasing whether due and proper actions for recovery are taken, the position regarding cases in co-operative courts, District Courts etc. and the results thereof.
- ii. **Overdue Interest** – Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue. In practice an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.
- iii. **Certification of Bad Debts** – A peculiar feature regarding the writing off of the bad debts as per Maharashtra State Co-operative Rules, 1961, is very interesting to note. As per Rule No. 49, bad debts can be written off only when they are certified as bad by the auditor. Bad debts and irrecoverable losses before being written off against Bad Debts Funds, Reserve Fund etc. should be certified as bad debts or irrecoverable losses by the auditor where the law so requires. Where no such requirement exists the managing committee of the society must authorise the write-off.
- iv. **Valuation of Assets and Liabilities** – However, regarding valuation of assets there are no specific provisions or instructions under the Act and Rules and as such due regard shall be had to the general principles of accounting and auditing conventions and standards adopted. The auditor will have to ascertain existence, ownership and valuation of assets. Fixed assets should be valued at cost less adequate provision for depreciation. The incidental expenses incurred in the acquisition and the installation expenses of assets should be properly capitalised. If the difference in the original cost of acquisition and the present market price is of far reaching

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significance, a note regarding the present market value may be appended; so as to have a proper disclosure in the light of present inflatory conditions. The current assets are valued at cost or market price, whichever is lower. Regarding the liabilities, the auditor should see that all the known liabilities are brought into the account, and the contingent liabilities are stated by way of a note.

- v. **Adherence to Co-operative Principles** – The auditor will have to ascertain in general, how far the objects, for which the co-operative organisation is set up, have been achieved in the course of its working. The assessment is not necessarily in terms of profits, but in terms of extending of benefits to members who have formed the society. Considered from the viewpoint of social benefits it may be looked into that how far the sales could be effected at lower prices. For the achievement of these activities, cost accounting methods, store control methods, techniques of standard costing, budgetary control etc. should be adopted. However, these modern techniques are mostly not in application and as such in practice a wide gap is found in the goals to be achieved and the actual achievements. While auditing the expenses, the auditor should see that they are economically incurred and there is no wastage of funds. Middlemen commissions are, as far as possible, avoided and the purchases are made by the committee members directly from the wholesalers. The principles of propriety audit should be followed for the purpose.
- vi. **Observations of the Provisions of the Act and Rules** – An auditor of a co-operative society is required to point out the infringement with the provisions of Co-operative Societies Act and Rules and bye-laws. The financial implications of such infringements should be properly assessed by the auditor and they should be reported.
- vii. **Verification of Members' Register and examination of their pass books** – Examination of entries in members pass books regarding the loan given and its repayments, and confirmation of loan balances in person is very much important in a co-operative organisation to assure that the entries in the books of accounts are free from manipulation. Specifically in the rural and agricultural credit societies, members are not literate and as such this is a good safeguard on their part. Of course this checking will be resorted to on a test basis, which is a matter of judgement of the auditor.
- viii. **Special report to the Registrar** – During the course of audit, if the auditor notices that there are some serious irregularities in the working of the society he may report these special matters to the Registrar, drawing his specific attention to the points. The Registrar on receipt of such a special report may take necessary action against the society. In the following cases, for instance a special report may become necessary:
  - (i) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.



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- (ii) Detection of fraud relating to expenses, purchases, property and stores of the society.
  - (iii) Specific examples of mis-management. Decisions of management against co-operative principles.
  - (iv) In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.
- ix. Audit classification of society** – After a judgement of an overall performance of the society, the auditor has to award a class to the society. This judgement is to be based on the criteria specified by the Registrar. It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification. The auditor should be very careful, while making a decision about the class of society.
- x. Discussion of draft audit report with managing committee** – On conclusion of the audit, the auditor should ask the Secretary of the society to convene the managing committee meeting to discuss the audit draft report. The audit report should never be finalized without discussion with the managing committee. Minor irregularities may be got settled and rectified. Matters of policy should be discussed in detail.

### 15. NBFCs, normally fall into following categories:

- A. Non-Banking Financial Company** - In terms of the section 45-I(f) read with section 45-I (c) of the RBI Act, 1934, as amended in 1997, NBFC is one whose principal business is that of receiving deposits or that of a financial institution, such as lending, investment in securities, hire purchase finance or equipment leasing. Such companies may also be categorised as under:
- (i) Equipment leasing company engaged in equipment leasing or financing of such activity.
  - (ii) Hire purchase finance company engaged in hire purchase transaction or financing of such transactions.
  - (iii) Investment company engaged in acquisition of securities and trading in such securities to earn a profit.
  - (iv) Loan company engaged in providing finance by making loans or advances, or otherwise for any activity other than its own; excludes EL/HP/Housing finance Companies (HFCs).
  - (v) Residuary non-banking company (RNBC) which receives deposits under any scheme or arrangement, by whatever name called, in one lump-sum or in

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instalments by way of contributions or subscriptions or by sale of units or certificates or other instruments, or in any manner. These companies do not belong to any of the categories as stated above.

- B. Mutual Benefit Financial Company (MBFC) i.e. Nidhi Company** - Any company which is notified by the Central government under section 620A of the Companies Act 1956 (1 of 1956).
- C. Mutual Benefit Company (MBC), i.e., Potential Nidhi Company** - A company notified under section 620A of the Companies Act, 1956 and by the Central Government, having minimum Net Owned Funds and Preferential Share Capital of Rs. 10 lakh, has applied to the RBI for Certificate of Registration and also to Ministry of Company Affairs (MCA) for declaration as nidhi company and has not contravened directions/regulations of Reserve Bank/MCA.
- D. Miscellaneous Non-Banking Company (MNBC), i.e., Chit Fund Company** - Managing, conducting or supervising as a promoter, foreman or agent of any transaction or arrangement by which the company enters into an agreement with a specified number of subscribers that every one of them shall subscribe a certain sum in instalments over a definite period and that every one of such subscribers shall in turn, as determined by lot or by auction or by tender or in such manner as may be provided for in the arrangement, be entitled to the prize amount.

#### **Special Points in the Audit of Non-Banking Equipment Leasing Finance (NBELF) Company**

- (i) Ascertain whether the NBFC has an adequate appraisal system for extending equipment leasing finance.
  - (ii) The auditor should verify whether there is an adequate system in place for ensuring installation of assets and their periodical physical verification. In respect of some major transactions, an auditor should arrange for physical verification of the leased assets so as to dispel any doubts that equipment leasing finance was not extended without the corresponding assets being created.
  - (iii) Ascertain whether the NBFC has an adequate system for monitoring whether the assets have been adequately insured against and regular maintenance of the leased assets is being carried out by the lessee.
  - (iv) Verify the lease agreement entered into with the lessee in respect of the equipment given on lease.
  - (v) An auditor should verify whether the AS 13 issued by the Institute of Chartered Accountants of India in respect of "Accounting for Lease" has been compulsorily followed.
- 16. Audit of Public Trusts** – The audit programme for the audit of public trust under section 12A of the Income-tax Act, 1961 is outlined in the following paragraphs:

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### **(a) Preliminary**

- (i) Obtain a resolution from the trust specifying the appointment as also indicating the scope of audit. In particular, the resolution should specify the duties of the auditor in relation to the items specified in the annexure to the prescribed Form No. 10B.
- (ii) Obtain a letter of appointment from the trust. Although the audit may have been conducted in the past by a person appointed as an auditor for the purpose of section 12A, having regard to the spirit of the requirement contained in clause (8) of Part-I of Schedule I to the Chartered Accountants Act, 1949, it is suggested that the auditor appointed for the purpose of section 12A, should, before accepting the audit, communicate with such previous auditor.
- (iii) Obtain a certificate as to the opening balances of assets and liabilities and the fund.
- (iv) Obtain a list of books of accounts which are maintained by the trust.
- (v) Obtain a certificate from the trust as to the system of accounting and internal control.
- (vi) Obtain from the trust a list of the institutions/ activities run/carried out by the trust.
- (vii) Obtain from the trust a certified true copy of the Deed of Trust or any other scheme containing the objects and conditions of the trust as operative from time to time.

### **(b) Routine Checking**

- (i) Check the books of account and other records having regard to the system of accounting and internal control.
- (ii) Vouch the transactions of the trust to satisfy that:
  - (a) the transaction falls within the ambit of the trust;
  - (b) the transaction is properly authorised by the trustees or other delegated authority as may be permissible in law;
  - (c) all incomes due to the trust have been properly accounted for on the basis of the system of accounting followed by the trust;
  - (d) all expenses and outgoings appertaining to the trust have been recorded on the basis of the system of accounting followed by the trust; and
  - (e) amounts shown as applied towards the object of the trust are covered by the objects of the trust as specified in the document governing the trust.
- (iii) Obtain a trial balance on the closing date certified by the trustees.
- (iv) Obtain the Balance Sheet and Profit & Loss Account of the trust authenticated by the trustees and check the same with the trial balance with which they should agree.

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#### **(c) Accounting Principles**

The auditor should follow, i.e., generally accepted accounting principles and ascertain the accuracy, truth and fairness of the Balance Sheet and Profit & Loss Account.

In particular, the auditor will scrutinise that:

- (i) all assets of the trust are verified;
- (ii) the assets of the trust have been properly valued and depreciation duly provided for;
- (iii) all liabilities of the trust are properly accounted for;
- (iv) the investments of the trust are properly classified and indicated and market values shown; and
- (v) outstanding due to the trust are properly accounted for and their recoverability examined and provision made for irrecoverable.

#### **(d) Annexure to the Audit Report:**

- (i) Obtain from the trustees, a certified list of persons covered by section 13(3).
- (ii) Obtain from the trustees, a statement enlisting the various items specified in the Annexure to Form No. 10B and giving the information against each item together with explanatory or supporting schedules.
- (iii) Verify the information supplied by the trustees in the statements specified above in the light of available material. Where a list of persons specified in section 13(3) is not available, indicate against Sections II and III of the items specified in the annexure the appropriate qualifying remarks.

The audit report is required to be furnished to the relevant year. Failure to furnish the report will disentitle the trust or institution to the benefit of sections 11 and 12. The Auditor can accept as correct the list of persons covered by section 13(3) as given by the managing trustees.

- 17. (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:

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- ◆ 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 therefore.

- (b) **Advantages of Cost Audit:** Cost Audit will be advantageous to the stockholders in the following manner:

**(1) To Management**

- (i) Reliability of data for price fixing, control and decision making.
- (ii) Waste control and consequently cost reduction.
- (iii) Through the system of budgetary control and standard costing, cost control is established.
- (iv) Proper valuation of closing stock, work in progress.

**(2) To Society**

- (i) Cost Audit is often introduced for the purpose of price fixation. Customers are saved from exploitation through proper costing of products and services.
- (ii) Since price increase by some industries is not allowed without proper justification as to increase in cost of production, inflation through price hikes can be controlled and consumers can maintain their standard of living.

**(3) To Shareholders**

Cost Audit ensures that proper records are kept as to purchases and utilization of materials and expenses incurred on wages etc. It also makes sure that the valuation of closing stock and work-in-progress is on a fair basis. The shareholders are assured about the calculation of the profitability and thus return on their investments.

**(4) To Government**

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- (i) In a cost plus contract, price fixation is properly calculated.
- (ii) Price ceiling for essential commodities and thus undue profiteering is checked.
- (iii) Able to monitor inefficient units
- (iv) Decision support on Government protection to certain industries.
- (v) Settlement of trade disputes.

Cost audit and consequent management action can create a healthy competition among the various units in an Industry. This imposes an automatic check on inflation.

18. Environmental Audit is a management tool comprising a systematic, documented, periodic and objective evaluation of how well environmental organisation, management and equipment are performing with the aim of helping to safeguard the environment by facilitating management control of environmental process and assessing compliance with company policies, which would include meeting regulatory requirements.

The main areas of the Environmental Audit in respect of various industrial units are as follows:

- (i) **Layout and Design** – The layout to be sketched in the style which will allow adequate provisions for installing pollution control devices, as well as provision for upgradation of pollution control measures and the meeting of the requirements of the regulations framed by the Government. In the course of the audit, the areas which require attention but not attended to by the industry to be pinpointed as well as the future requirements of the environmental measures required in commensuration with the proposed future course of working plan are to be identified.
- (ii) **Management of Resources** – Management resources includes air, water, land, energy, raw materials and human resources besides others. The use of all resources is interlinked and the best uses in a synchronised manner results the best output and minimum waste. The waste of resources to the minimum possible extent is good for the health of the industry as well as the environment.
- (iii) **Pollution Control System** – An effective system of pollution control should be in existence. One aspect should be whether all required pollution control measures are in vogue or not next aspect should be whether the same is effective or not, further it is to investigate, whether more measures are required, keeping in view the type of industry and its nature of working with respect to its grade of polluting the environment.
- (iv) **Emergent Safety Arrangement** – The chemical, gas, etc., industries which are prone to sudden requirement of safety arrangements, must remain alert all the

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while. The emergency plans are to be reviewed periodically, sufficient staff along with other required safety amenities should be kept ready. The staff, remained so engaged, must possess the required awareness and alertness to meet the contingency. The degree of awareness, however, can be upgraded with proper training provisions.

- (v) **Medical & Healthcare Facilities** – The medical services should be maintained. The health of the workers should be a big consideration for the management.
  - (vi) **Industrial Hygiene** – Proper system should be in vogue to eliminate industrial unhygienic state.
  - (vii) **Occupational Health** – The requirement for safeguarding against occupational health hazards should be available for all the workers. As the occupational health hazards varies from industry to industry due to the difference in the nature of working atmosphere and the pollutants present in it, the concerned industry must pay proper weightage to those diseases which are prone to that particular type of industry.
  - (viii) **Information Assimilation and Reporting System** – The information system should be strengthened to generate and its reporting system should be proper, keeping in view, the authorities, responsibilities and subsequent delegations. A report of compliance of all statutory environmental laws along with other preventive and precautionary measures should be put to Board at regular intervals.
  - (ix) **EIA Methodology** – The Environmental Impact Assessment (EIA) is usually are pre-requisites to start an industry. This is done considering the known spheres of activities on the existing environmental conditions. But the predictions necessarily deviate from the actual happenings when the industry starts working. To accommodate the deviation in the system is also to be incorporated in the EIA report, if it is noticed that the degradation to the environment caused on the establishment and running of the industry is much higher than what was predicted, the mitigatory measures suggested must also be furthered.
  - (x) **Compliance to the Regulatory Mechanism** – As the persons who are directly working with the system, may be unaware of the latest developments and requirements for the compliance of stipulations and standards prescribed by the various regulatory authorities, they should be trained and instructed on regular basis, to avoid making the Board/owner vulnerable to prosecution and penalty.
  - (xi) **Concern for the Society** – The industry very often transforms the agrarian environment into an industrial environment. The people so displaced by industrialisation feel alienated and develop a feeling of facing the gaseous, dustful, clumsy state of surroundings. The audit should look into this aspect how the industry is making a balance between its own development and the society's concern.
19. **Comprehensive Audit of Public Enterprises: Areas to be examined:** The scope and extent of audit of public sector enterprises is determined by the Comptroller and Auditor

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General of India. Audit of public enterprises in India is not restricted to financial and compliance audit; it extends also to efficiency, economy and effectiveness with which these operate and fulfill their objectives and goals. Another aspect of such audit relates to questions of propriety; this audit is directed towards an examination of management decisions in sales, purchases, contracts, etc. to see whether these have been taken in the best interests of the undertaking and conform to accepted principles of financial propriety. Comprehensive audit involves assessing efficiency and effectiveness of public enterprises in its entirety to be conducted on the basis of certain standards and criterion. Public enterprises have been set-up with socio-objectives. An objective assessment with reference to such objectives' fulfillment would require comprehensive audit.

The starting point of a comprehensive audit of a public enterprise, which covers aspects of economy, efficiency and effectiveness, is the preparation of an audit programme based on the study of decisions relating to the setting up of the enterprise, its objectives, the areas of operation, organisation, financial and operational details available in the annual reports and accounts, capital and operational budgets, deliberations of the board of directors, material in the earlier audit inspection reports on the enterprise and other relevant available papers. These audit programmes (or guidelines) identify the areas/aspects which require further detailed audit analysis and criteria, the data required for such analysis and the sources of such data, the extent of the audit analysis including the test checks to be applied and the instructions to the audit parties assigned to the work.

The areas covered by comprehensive audit are those of investment decisions, project formulation and management, organisation, delegation of powers and management information systems, organisational effectiveness, capacity utilisation, management of equipment, plant and machinery, production performance, use of materials, productivity of labour, idle capacity, costs and prices, development of complementary ancillary small scale industries, materials management, sales and credit control, budgetary and internal control systems, etc. The areas covered in comprehensive audit will naturally vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations. Some of the broad areas are listed below:

- ◆ Comparison of overall capital cost of the project with the approved planned costs.
  - ◆ Production or operational outputs vis-a-vis under-utilisation of the installed capacity.
  - ◆ Systems of project formulation and implementation.
  - ◆ Cost control measures.
  - ◆ Research and development programmes.
  - ◆ System of repairs and maintenance.
20. Adequate working capital is required for liquidity and smooth operations of the company. To ensure an adequate flow of working capital to the manufacturing company, the following action plan may be considered:



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- (i) **Working Capital Estimation:** The company should start by preparing a statement of the projected working capital requirements. This should be based on the functional budgets in sales, production, expenses, capital expenditure and the master budget consisting of projected profit and loss and the balance sheet.
  - (ii) **Cash Flow Statement/Cash Budget:** Month-wise cash budgets showing inflows and outflows of cash heading-wise should be prepared to analyse the major inflows and outflows affecting the entity. At this stage any wasteful outflow can be traced and eliminated. Bank reconciliation should be undertaken periodically so that outstandings can be traced and acted upon. This is also necessary to reduce the float time.
  - (iii) **Inventory/Stock Management:** Raw materials and inventories should be classified properly to determine the level of stock of materials. The method of costing also needs to be looked at minutely. There is a need to establish linkage with the production pattern and work backwards accounting for time factor in receipt of material. This needs to be worked out carefully since at no cost, production schedule should be hampered. The caution also needs to be exercised that there is no unused/obsolete inventory. The system of inventory management needs to be looked at so as to check the avoidable wastes/scrap generated during storage and handling. Just in time philosophy will enable the company to reduce processing time, stocks and related costs. The adoption of such a mechanism would bring down the cost to a considerable extent.
  - (iv) **Credit Management:** The Company should lay down a proper policy for evaluating customers, determining the credit period and offering discounts for early payment. An age-wise analysis of debtors should also be prepared so as to avoid credit to defaulters. The sale department needs to be geared up so that realisation can be made in time. A careful analysis should be done of various customers according to pattern of sales so as to exercise control on their respective debit balances. The company should through its purchase department endeavour to avail the maximum credit period from its creditors. This would enhance the working capital of the company.
  - (v) **Funds Flow Analysis:** The Company should prepare a funds flow analysis, distinguishing between long-term and short-term sources and applications.
  - (vi) **Investment Management:** The idle funds of the company, if any, should be invested in short-term securities to augment the income.
  - (vii) **WIP Analysis:** Minimum WIP should be monitored and for the purpose it is necessary to ensure that no bottlenecks develop at any stage during the production process.
- 21. Steps involved while conducting investigation on behalf of an incoming partner:**  
The general approach of the investigating accountant in this type of investigation would be more or less similar, irrespective of the nature of business of the firm-manufacturing, trading or rendering a service. Primarily, an incoming partner would be interested to know whether the terms offered to him are reasonable having regard to the nature of the

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business, profit records, capital distribution, personal capability of existing partners, socio-economic setting, etc. and whether he would be capable for services to be rendered, which can be justified by the overall economic conditions prevailing and other considerations considering his own personality and achievements. In addition, he would be interested to ascertain whether the capital to be contributed by him would be safe and applied usefully. Broadly, the steps should be taken by X on behalf of S are as under:

- (a) Ascertaining the history of the firm PQR Ltd since inception and growth of the firm.
- (b) Studies of the provisions of the Deed of Partnership, particularly for composition of partners, their capital contribution, drawing rights, retirement benefits, job allocation, etc.
- (c) Scrutiny of the record of profitability of the PQR Ltd's business over a suitable number of years, with usual adjustments that are necessary in ascertaining the true record of business profits. Particular attention should, however, be paid to the nature and profitability of the business, qualification and expertise of the partners and such others as may be relevant.
- (d) Examination of the asset and liability position to determine the tangible asset, partners, investment, appraisal of the value of intangibles like goodwill, know-how, patents, etc impending liabilities including contingent liabilities and those for pending tax assessment.
- (e) Assess position of order at hand and the range and quality of clientele should be thoroughly examined under which the PQR Ltd. is presently operating.
- (f) Scrutinise terms of loan finance to assess its usefulness and the implication for the overall financial position.
- (g) Study important contractual and legal obligations should be ascertained and their nature studied. It may be the case that the firm PQR Ltd. has standing agreement with the employees as regards salary and wages, bonus, gratuity and other incidental benefits. Full import of such standing agreements would be gauged before a final decision is reached.
- (h) Study the composition and quality of key personnel employed by the PQR Ltd and any likelihood of their leaving the organisation.
- (i) Ascertain reasons for the offer of admission to a new partner and it should be determined whether the same synchronizes with the retirement of any senior partner whose association may have had considerable impact having on the PQR Ltd's successes.
- (j) Appraisal of the record of capital employed and the rate of returns. It is necessary to have a comparison with alternative business avenues for investments and evaluation of possible results on a changed capital and organisation structure.
- (k) Ascertain manner of computation of goodwill on admission as also on retirement, if any.

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- (I) Examine whether any special clause exist in the Deed of Partnership to allow admission in future a new partner.

**22. Illustrative Checklist of Audit Programme of a Reviewee** - A checklist which illustrates the contents of the audit programme of a reviewee for the guidance of the reviewer is given hereunder:

- Appointment and the relevant resolution about the appointment.
- Terms of the engagement including reports required and manner of determining audit fees.
- System of book-keeping and the list of the books of accounts maintained by the entity.
- Particulars of the promoters, directors and their powers.
- Names of persons who write the books of accounts and other authorised officers.
- Memorandum and Articles of Association, Partnership Deed as applicable.

Details of business of client and its accounting systems by reviewing and assessing information on:

- Nature of business of the entity; and
- The internal control system including owner/manager controls.
- Profit and loss account, balance sheet, auditor's and directors' reports of the previous year and the reports of internal auditor.

Analytical review procedures in order to:

- identify areas of accounts which are important because of their size;
- highlight unusual or unexpected figures or relationships in the accounts;
- Design audit test which concentrates on important and unusual items; and
- obtain sufficient audit assurance to allow the reduction or even elimination of detailed testing in some areas.
- Assessment of audit risk by using the professional judgement and audit procedures to ensure that it is reduced to an acceptably low level.
- Preliminary estimates of materiality for the audit as a whole.
- Class of accounting transactions which are relevant and to decide the type of testing and samples.
- Selection of representative samples.
- Compliance tests to evaluate the reliability of key controls.
- Material weaknesses in the operation of key controls to management.
- Performance of analytical review procedures, substantive tests of detail to obtain sufficient, relevant and reliable audit evidence for each audit objective.

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- Fundamental accounting assumptions i.e., consistency, going concern and accrual basis of accounting are followed by the client in the preparation and presentation of financial statements.
- Any change in an accounting policy which has a material effect have been disclosed.
- Audit report is received from all the Branch Auditors and any reservation made by the branch auditor is appropriately dealt with in the finalisation of accounts.
- Working papers contain all audit evidence, and are cross-referenced.
- Summary of work done, problems, important judgements and audit conclusions.
- Review by senior incharge of work of all assistants, audit programme followed and work performed as per time schedule.
- Permanent file updated throughout the audit.
- Review of unadjusted errors to determine whether individual and aggregate effect is material.
- Compliance with Companies Act, 1956 and other relevant statutory requirements.
- Compliance of all mandatory Accounting Standards issued by the Institute.
- Post balance sheet events.
- Formulation of draft audit opinion.
- Comparison of budgeted time to actual and reasons for major variations.
- Complete staff evaluation forms.
- Planning of next year's audit and including it in the permanent audit file.

Finally, the reviewer may decide to employ substantive procedure only in case he is unable to place reliance in specific control procedures. The application of substantive review procedures would involve inspection of working papers of the attestation engagement.

- 23.** Following are some provisions of the Sarbanes-Oxley Act of 2002, which, if enacted in India may be further fruitful in respect of Indian corporate:
1. More independence to be given to Audit Committee and auditor.
  2. Ban on personal loan to Directors / Executive Officers of a Company
  3. Strict reporting by an auditor on insider trading.
  4. Additional disclosures imposed on financial reporting.
  5. If there is any conflict between company and its auditor, the Audit Committee should be empowered to resolve the same.
  6. Higher penalties and criminal prosecution on financial frauds.
  7. To include effectiveness of Internal Control System in the financial reporting.

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8. More responsibilities must be imposed on managerial personal with higher penalties and prosecutions on the breach.
  9. Strict action against white collar crime.
  10. Disclosures of the % of shareholdings by Directors, Executive Officers and principal shareholders.
24. (a) **Failure to Exercise Reasonable Care and Skill:** Apparently, as it appears from the facts of the case that the auditor did not exercise proper skill and care and that he performed his work in a desultory and haphazard manner. In this matter, the test for auditor's liability lies in whether he has applied reasonable care, skill and caution called for in the circumstances of the case and whether he reasonably used all the information that he came across in the course of audit.

Cash is a very significant item in any situation and the fact that the cashier had left during the year without notice should have placed the auditor on alert as regards the cash book. In fact, the very fact that the cashier was absconding, i.e., left without any notice constituted sufficient circumstances to excite suspicion of the auditor to probe to the bottom. As per SA 240, "The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements", it can be concluded that the auditor did not plan and perform the audit with an attitude of professional skepticism. Thus, having regard to this and a fraud has actually taken place during the year, committed by the absconding cashier, it is reasonable to think that prima facie there is a case against the auditor for gross negligence.

Clause (7) of Part I of Second Schedule to the CA Act, 1949 requires that it is the duty of an auditor to bring to bear in the work he has to perform that skill, care and caution as per the circumstances in an honest and reasonable manner. As it appears from the facts of the case, the auditor has been grossly negligent in performing his duties which constitutes professional misconduct.

### **Conclusion:**

Thus, such instances require reference to Disciplinary Committee of the Council of the Institute. If a member is found guilty by the Council of any of the acts or omissions stated in the Schedule, its finding with recommendations are to be referred to the High Court for decision.

- (b) Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 states that a chartered accountant in practice shall be deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of the client or otherwise than as required by law for the time being in force. SA 200 on "Basic Principles Governing an Audit" also reiterates that, "the auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose". In the instant case, the bank has asked the auditor for detailed information regarding few items in the financial

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statements available in his working papers. Having regard to the position stated earlier, the auditor cannot disclose the information in his possession without specific permission of the client as far as working papers are concerned, SA 230 on "Audit Documentation" states "working papers are the property of the auditor. The auditor may at his discretion, make portions of or extracts from his working papers available to his client".

#### **Conclusion:**

Thus, there is no requirement compelling the auditor to divulge information obtained in the course of audit and included in the working papers to any outside agency except as and when required by any law.

- (c) As per Clause 8 of Part I of First Schedule to the CA Act, 1949, A chartered accountant in practice is deemed to be guilty of professional misconduct if he accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been issued certificate under the Restricted Certificates Rules 1932, without first communicating with him in writing.

In the instant case, BC & Co. accepted VAT – audit under State Level Act, carried out by another firm of chartered accountants in the previous year, without prior communication with the previous auditor.

#### **Conclusion:**

A communication is mandatory requirement for all types of audit, if the previous auditor is a chartered accountant. Hence, the firm is guilty of professional misconduct.

- (d) As per Clause 5 of Part I of Second Schedule to the Chartered Act, 1949, if a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he fails to disclose a material fact known to him which is not disclosed in the financial statement, but disclosure of which is necessary in making such financial statement in a professional capacity.

In the instant case, Q was in duty bound to see that the nature and subject matter of the charge over a security and the nature and mode of valuation of the Sinking Fund Investments were disclosed in the Balance Sheet of Z Ltd., in accordance with Form F.

#### **Conclusion:**

Hence, Q was found guilty of misconduct.

- (e) **Responding to Tenders:** Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 lays down guidelines for responding to tenders, etc. As per the guidelines if a matter relates to any services other than audit, members can respond to any tender. Further, in respect of a non-exclusive area, members are permitted to pay reasonable amount towards earnest money/security deposits.

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In the instance case, since computerisation of property takings records does not fall within exclusive areas for chartered accountants, M/s AVQ can respond to tender as well as deposit Rs.40,000 as earnest deposit and shall not have committed any professional misconduct.

**25. (a) Factors to consider in determining the use of Computer Assisted Audit Techniques**

- (i) The IT knowledge, expertise and experience of the audit team.
- (ii) The availability of CAATs and suitable computer facilities and data.
- (iii) The impracticability of manual tests due to complex processing needed.
- (iv) Effectiveness and efficiency in evaluating evidence involving large population.
- (v) Time constraints.

The above is in consonance with the guidance note on Computer Assisted Audit Techniques.

- (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. Annexure 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 through 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 required 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.

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- (c) **Audit vs. Investigation:** Etymologically, auditing and investigation are largely overlapping concepts because auditing is nothing but an investigation used in a broad sense. Both auditing and investigation are fact finding techniques but their basic nature and objectives differ as regards scope, frequency, basis, thrust, depth and conclusiveness. Audit and investigation differ in objectives and in their nature. Auditing is general while investigation is specific. The object of auditing is to ensure that the financial statements are free and fair and not misleading or unreliable. The merit of auditing lies in its ability to pronounce in general terms whether the accounts are basically reliable or not and in accordance with the legal requirements and regulations applicable to the particular audit. Audit is not based on suspicion unless circumstances exist to arouse suspicion of the auditor.

Investigation implies systematic, critical and special examination of the records of a business for a specific purpose. The examination conducted under investigation is intensive as well as exhaustive so far as the activities or areas of accounting is concerned. Investigation requires a concentrated focus on the subject matter of inquiry and related matters. Often, investigations may spread over a period longer than one year and its scope may extend to inquiry beyond the books of accounts if the circumstances so require.

(d) **Facultative Re-Insurance**

It is that type of reinsurance whereby contract relates to one particular risk and is expressed in the reinsurance policy. Each transaction has to be negotiated individually. Each party has free choice i.e., ceding company to offer and insurer to accept. The Insurance is used when:

- (i) Automatic cover has exhausted.
- (ii) Risk is excluded from treaties
- (iii) Reinsurance treaties have not to be over burdened for abnormal risks.
- (iv) When insurer has no automatic cover.
- (v) Where technical guidance is required at each stage of acceptance of risk.