

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS
QUESTIONS

Standards on Auditing, Statements and Guidance Notes

1. The directors of C Ltd. are concerned about the reliability and usefulness of the monthly financial management information that they receive.
As a result, the company's auditors have been engaged to review the system and the information it generates, and to report their conclusions.
 - (a) What an ordinary procedure includes for the review of financial statements?
 - (b) Contrast this assignment with the statutory audit of the company's financial statements with regard to the scope of the assignment and to the report issued.
2. The training partner in your office is aware that you have covered SA 550 *Related Parties* in your Professional studies. He has asked you to help him prepare for a training session he is about to give.

Requirements

Prepare notes for a training session for junior staff on how to identify related party transactions. Your notes should include

- (a) A list of possible features which would lead you to investigate a particular transaction to determine whether it is in fact a related party transaction.
- (b) A summary of the general audit procedures you would perform to ensure that all material related party transactions have been identified.

Audit Strategy Planning and Programming

3. Your new client, XYZ Ltd, sells cars, parts and accessories and undertakes workshop repairs. The company operates through five divisions/locations in the Mumbai. Each division deals with a different overseas vehicle supplier and has three managers, one for each trading activity. Each division makes sales to companies and individuals, but only corporate customers are granted credit terms.

The computer-based accounting systems are based in the head office which is annexed to the premises of the largest division. All nominal ledger codes are suffixed 1 to 5 identify each division's transactions.

Detailed inventory records include date of movements, original purchase price and latest selling price. Purchase requisitions are computer-generated when inventory line quantities fall to pre-determine re-order levels.

Gross selling prices for cars and parts are established on receipt of each consignment at standard markups on cost, as specified in the franchise agreements with each manufacturer. Parts transferred to workshops are charged at cost plus 10%. At the end of each month the computer generates trading and profit and loss accounts and balance sheets for each division, and 'consolidated' results for the company. New car sales

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managers prepare monthly returns showing the number of cars sold, gross selling prices extra and discounts.

All salaries and wages are processed centrally at head office. Divisional managers all have *profit-related bonus incentives*.

Requirement

Identify, from the situation outlined above, circumstances particular to XYZ Ltd that should be taken into account when planning the audit. Briefly explain why these matters should be taken into account and set out the effect on our audit approach.

Risk Assessment and Internal Control

4. You are the senior auditor in charge of the audit of Bianca Ltd., a manufacturing company. You have been talking with the payroll supervisor who has commented on the strength of the company's payroll internal control system. She has assumed that this internal control system guarantees the completeness, accuracy and validity of the payroll accounting records.

Requirements

- (a) State whether you agree with the supervisor's assumption that an internal control system can guarantee the completeness, accuracy and validity of the records, supporting your answer by using examples from a payroll system.
- (b) The supervisor has also asked you to explain some internal control terminology which she does not understand. Explain the meaning of the following terms, using payroll examples different from those you have given above.
 - (i) Segregation of duties
 - (ii) Approval and control of documents

Audit under CIS Environment

5. (a) Zantacs, a limited company having turnover of approximately ₹ 80 crores uses a tailor made accounting software package. In the said package, all transactions are recorded, processed and the final accounts generated from the system. The management tells you that in view of the voluminous nature of day books, there is no need to print them and that audit can be conducted on the computer itself. The management further assures you that any 'query based reports' as required can be generated and printed. As a statutory auditor of the company, enumerate the procedures you would adopt to conduct the audit.
- (b) "The auditor must evaluate major clauses of control used in a Computerised Information system to enhance its reliability" – Comment.

The Company Audit

6. (a) A public limited company i.e. 'the Indian company' whose shares are listed on the Bombay Stock Exchange is engaged in the business of manufacture and sale of

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electrical and electronic items. During the financial year 2009-10, the company acquired a company in Singapore carrying on similar business. The Singapore company's shares were acquired through a subsidiary of the Indian company in the Malaysia.

The acquisition was completed in May 2009 and the Indian company has incurred the following expenses up to May 2009, for the acquisition of the Singapore company:

S. No.	Expenses incurred	INR (in Lakh)
1.	Travelling Expenses	200
2.	Legal Expenses	100
3.	Due Diligence Expenses	100
4.	Other Expenses	50
	Total	450

The Indian company has remitted an amount of US\$ "x" to its subsidiary in the Malaysia for acquiring the shares. The Malaysian subsidiary actually incurred only US\$ "y" for the acquisition of the shares of the Singapore company and remitted back the balance US\$ (x-y) to the Indian company. On account of this excess money returned, the Indian company has incurred an exchange loss of Indian Rupees 200 lakh (approx)

Requirement

- (i) Whether the amount of expenditure incurred by the Indian company can be treated as part of the cost of investment.
 - (ii) Whether the exchange loss incurred by the Indian company on account of sending and receiving back excess US\$ from its Malaysian subsidiary can be treated as part of the cost of investment.
- (b) Give your views together with reasons on the following proposals:
- (i) A company had profit after depreciation and tax of ₹ 17,00,000 for the year 2009-10.

In arriving at this profit a deduction was made of ₹.3,00,000 in respect of the reserve created on account of Shipping Reserve. The company has proposed a rate of dividend @15% on its equity capital of ₹.6,00,000 and 10% on the preference capital of ₹. 6,00,000. The company also proposes to transfer to reserves 10% of the current profit.

- (ii) The rates of equity dividend declared and paid by a company are as follows:

2008-2009	15%
2007-2008	12%
2006-2007	12%

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The company has earned sufficient profit after tax in 2009-10 and wishes to propose a dividend on equity shares at 11% of the current profits and transfer to Reserve 20%. The company has not issued any bonus shares during the last few years. The post-tax profit in 2009-10 is higher than the corresponding profit of each of the previous three years.

- (iii) Will it make any difference if the company under (ii) above proposed a rate of equity dividend @ 20%?
- (iv) Will it make any difference if the amounts of net profits after tax of the company under (ii) above are as follows?

	₹
2009-2010	10,00,000
2008-2009	17,00,000
2007-2008	15,00,000
2006-2007	18,00,000

- (v) A company's profits after tax for several years and equity dividends are given below:

Years	Net profit after tax (₹)	Rate of equity dividend	Amount of dividend (₹)
2010-2009	10,00,000	8% (proposed)	8,00,000
2009-2008	17,00,000	14% (paid)	14,00,000
2008-2007	15,00,000	12% (paid)	9,60,000
2007-2006	16,00,000	10% (paid)	8,00,000

The company wishes to transfer to reserves ₹ 2,00,000 of the current profits. It issued bonus shares during 2008-09.

Liabilities of Auditors

7. (a) You are the auditor of a company, which raised finance from the capital market on the basis of a prospectus issued a few years back. The main object for raising the finance was specified to be setting up a project on information technology.

The company advanced monies so raised to various parties 'related' to directors. These parties had no standing whatsoever with information technology. In the Balance Sheet, these advances appeared as a current asset under the head "loans unsecured – considered good". There was no mention in the notes to accounts about nature and purpose of such advances. You have given routine audit report without any qualifications. One fine morning the directors and these 'related' parties disappear. The company has just vanished.

Can you be hauled up for professional misconduct? Do you have any liability under any law?

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- (b) Briefly explain the auditor's liability in case of unlawful acts or defaults by clients

Audit Report

8. The audit report of P Ltd. for the year 2008-09 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2009-10, how would you report, if?
- (a) The company does not make provision for doubtful debts in 2008-09?
- (b) The company makes adequate provision for doubtful debts in 2008-09?
9. As the statutory auditor of B Ltd. to whom CARO, 2003 is applicable, how would you report in the following situations?
- (a) The company has stood guarantee to its sister concern, whose financial condition was not healthy for a sum of ₹ 20 lakhs borrowed from a bank.
- (b) Physical verification of only 50% (in value) of items of inventory has been conducted by the company. The balance 50% will be conducted in next year due to lack of time and resources.
- (c) Accumulated losses of the company are 50.9% of its net worth and it is incurring continuous cash losses since last 2 years.

Audit Committee and Corporate Governance

10. (a) Section 292A of the Companies Act, 1956 provides that every Public Company having paid up capital not less than ₹ 5 crores shall constitute a Committee of the Board known as "Audit Committee". Briefly discuss the additional requirements as per Section 292A, which are silent in clause 49 of the Listing Agreement.
- (b) Explain the Constitution and functions of Audit Committee under Section 292A of the Companies Act, 1956.

Audit of Consolidated Financial Statements

11. (a) "Permanent Consolidation Adjustments are made only on the first occasion of the preparation and presentation of consolidated financial statements". Explain the role of auditor in the context of Permanent Consolidation Adjustments.
- (b) While doing the audit of consolidated Financial Statements, which current period consolidation adjustments are to be taken into account?

Audit of Banking Company

12. (a) As a branch auditor of a nationalised bank, how would you verify the following?
- (1) Advances to DOT COM Companies.
- (2) Balances in account of a bank situated in a foreign country.
- (b) As the concurrent auditor of Nagpur Main Branch of XYZ Bank Ltd. state the issues which have to be considered in the audit of advances.

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Audit of General Insurance Company

13. "In an audit of an insurance company, the Receipts and Payments Account is also subjected to audit". Comment.

Audit of Co-operative Society

14. Mention the duties of Auditor of Co-operative Societies in regard to the following:
- (a) Over-due interest.
 - (b) Compliance with provisions of Co-operative Act and Rules thereunder.
 - (c) Special Report to Registrar of Co-operative Societies.

Audit under Fiscal Laws

15. (a) Mr. X, who conducts the tax audit u/s 44AB of the Income-tax Act, 1961 of M/s ABC, a partnership firm has received the entire audit fees of ₹ 25,000 in April, 2010 in respect of the tax audit for the year ended 31.3.2010. The audit report was however signed in September, 2010. Comment.
- (b) A leading jewellery merchant used to value his inventory at cost on LIFO basis. However, for the current year, in view of requirements of AS 2, he changed over to FIFO method of valuation. The difference in value of stock amounted to ₹.55 lakhs which is higher than that under the previous method. In such a situation, what are the reporting responsibilities of a Tax Audit under Section 44AB of Income-tax Act, 1961.

Special Audit

16. (a) What are the key functions of an Energy Auditor?
- (b) State the items contained in the SEBI's check list for auditors in respect of contract notes issued by a Stock Broker.

Internal Audit, Management and Operational Audit

17. "Operational auditing is not different from internal auditing." Discuss.

Investigation and Due Diligence

18. Mr. Manak is above 80 years old and wishes to sell his proprietary business of manufacture of specialty chemicals. S Ltd. wants to buy the business and appoints you to carry out a due diligence audit to decide whether it would be worthwhile to acquire the business.

What procedures you would adopt before you could render any advice to S Ltd.?

Professional Ethics

19. (a) Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

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- (i) Mr. Ravi, a practicing Chartered Accountant agreed to select and recruit personnel, conduct training programmes for and on behalf of a client.
 - (ii) A practicing Chartered Accountant was appointed to represent a company before the tax authorities. He submitted on behalf of his clients certain information and explanations to the authorities, which were found to be false and misleading.
 - (iii) XY & Co., a firm of Chartered Accountants, included the name of P as a partner while filing an application for empanelment as auditor for Public Sector bank branches. It was subsequently noticed that on the date of application, P was not a partner with AB & Co.
- (b) Fair Ltd. is a small company which develops specialist software for the insurance and banking sector. Its finance director, Jagdish Kumar, has recently been on a training course called 'Reducing the Stress of an Audit'. He has returned to the office with a number of concerns which he had not previously known existed. As a result he has written to you as audit partner for clarification on the following issues.
- (i) Is it appropriate for your firm to continue as auditors when it also provides other services (most notably preparation of the company's corporation tax computation and dealing with the tax affairs of the directors)?
 - (ii) I have invited you to attend our regular board meetings but recognise that this may influence your audit opinion.
 - (iii) We have often sought your advice on legal and accounting issues, and I assume that it is in order for us to extend this to the preparation of submissions to the bank for additional finance.

The last point has particular significance as the finance director's letter also indicates that Proper Ltd. has been very successful, and intends to improve its status by buying a larger ailing computer company.

Requirements

Write a letter to the finance director which addresses the ethical issues arising from his concerns. The letter should be brief and deal with the major items only, as the intention is not to swamp the client with detail.

20. Write a short note on the following:
- (a) Classification of NBFCs
 - (b) Objectives of Peer Review
 - (c) General principles relating to propriety aspect.
 - (d) True and Fair Cost of Production.

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SUGGESTED ANSWERS/HINTS

1. (a) **Procedures for Review of Financial Statements:** As per SRE 2400 "Engagements to Review Financial Statements", procedures for the review of financial statements will ordinarily include:
1. Discuss terms and scope of the engagement with the client and the engagement team.
 2. Prepare an engagement letter setting forth the terms and scope of the engagement.
 3. Obtain an understanding of the entity's business activities and the system for recording financial information and preparing financial statements.
 4. Inquire whether all financial information is recorded:
 - (a) Completely;
 - (b) Promptly; and
 - (c) After the necessary authorisation.
 5. Obtain the trial balance and determine whether it agrees with the general ledger and the financial statements.
 6. Consider the results of previous audits and review engagements, including accounting adjustments required.
 7. Inquire whether there have been any significant changes in the entity from the previous year (e.g., changes in ownership or changes in capital structure).
 8. Inquire about the accounting policies and consider whether:
 - (a) They comply with the applicable accounting standards;
 - (b) They have been applied appropriately; and
 - (c) They have been applied consistently and, if not, consider whether disclosure has been made of any changes in the accounting policies.
 9. Read the minutes of meetings of shareholders, the board of directors and other appropriate committees in order to identify matters that could be important to the review.
 10. Inquire if actions taken at shareholder, board of directors or comparable meetings that affect the financial statements have been appropriately reflected therein.
 11. Inquire about the existence of transactions with related parties, how such transactions have been accounted for and whether related parties have been properly disclosed.

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12. Inquire about contingencies and commitments.
 13. Inquire about plans to dispose of major assets or business segments.
 14. Obtain the financial statements and discuss them with management.
 15. Consider the adequacy of disclosure in the financial statements and their suitability as to classification and presentation.
 16. Compare the results shown in the current period financial statements with those shown in financial statements for comparable prior periods and, if available, with budgets and forecasts.
 17. Obtain explanations from management for any unusual fluctuations or inconsistencies in the financial statements.
 18. Consider the effect of any unadjusted errors – individually and in aggregate. Bring the errors to the attention of management and determine how the unadjusted errors will influence the report on the review.
 19. Consider obtaining a representation letter from management.
- (b) Contrast of a review assignment with the statutory audit of the company's financial statements with regard to the scope of the assignment and to the report issued are hereunder:

SCOPE	
Review assignment	Statutory audit
<ul style="list-style-type: none"> Scope of Review assignments are generally falls in agreement between parties 	<ul style="list-style-type: none"> Scope of Statutory audit should be in accordance with the Companies Act, 1956 or in accordance with other statute.
<ul style="list-style-type: none"> Scope of Review assignments are restricted to instructions 	<ul style="list-style-type: none"> Scope of Statutory audit should be in accordance with Audit Regulations and Norms
<ul style="list-style-type: none"> Review assignment should be done in accordance with SREs 	<ul style="list-style-type: none"> Statutory audit should be conducted in accordance with SAs,14 Statements and Guidance Notes etc

REPORT	
Review assignment	Statutory audit
<ul style="list-style-type: none"> Report of Review Assignment is addressed to the board 	<ul style="list-style-type: none"> Statutory Audit Report is Addressed to the members
<ul style="list-style-type: none"> Format of Report of Review 	<ul style="list-style-type: none"> Statutory Audit Report is on true

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Assignment is wholly discretionary	and fair view and as per prescribed Format.
• Report of Review Assignment is private report	• Statutory Audit Reports are in public domain

2. Notes for a training session for junior staff on how to identify related party transactions

Purpose of the training

To assist junior staff in the application of AS 18 "*Related Party Disclosures*" and SA 550 "*Related Parties*", and specifically on how to identify related party transactions.

Related parties

As per AS 18 related parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. So in view of AS 18, related parties are individual or entities (example companies) with more than a simple business relationship with the client. This would be because they are directors, owners or major investors of the client and can include family and close friends of the directors or owners.

AS 18 further defines related party transactions as transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

At the start of each audit you will be provided with an up-to-date list of known related parties. It is important that if you come across any transactions involving these parties during the audit you should record them on the audit file.

The directors should provide us with a complete list of these related party transactions. However, we need to be certain that their lists is complete, and by comparing the transactions you find with the list from the directors we can obtain evidence as to its reliability.

General audit procedures

Unless we determine that the risk of non-disclosure of related party transactions is high, we gain a significant amount of evidence needs from general audit procedures. These are listed in (b) below.

Additionally, they may intentionally or otherwise leave out certain transactions from the list they provide and you therefore need to be aware of indicators of potential undisclosed related party transactions. These are given in (a) below.

If you notice any such transactions, record them on the audit file. If there are significant number of such transactions, immediately ask the manager for specific guidance on what action to take.

- (a) List of possible features which would lead you to investigate a particular transaction to determine and repayment terms.

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- Transactions which have abnormal terms of trade, for example unusual prices, interest rates, guarantees and repayment terms.
- Transactions which appear to lack a logical business reason for their occurrence.
- Transactions in which substance differs from form.
- Transactions processed or approved in a non-routine manner or by personnel who do not ordinarily deal with such transactions.
- Unusual transactions which are entered into shortly before or after the end of the financial period.
- Transactions which are overly complex (e.g., it may involve multiple related parties within a consolidated group).
- Transactions which involves previously unidentified related parties.
- Transactions which are processed in an unusual manner.
- Whether management is placing more emphasis on a particular accounting treatment rather than giving due regard to the underlying economics of the transaction.

If management's explanations are materially inconsistent with the terms of the related party transaction, the auditor is required, in accordance with SA 500, "Audit Evidence" to consider the reliability of management's explanations and representations on other significant matters.

- (b) Summary of the general audit procedures you would perform to ensure that all material related party transactions have been identified.
- Obtain a list of current known related parties, for example directors, other companies with common directors, family members of directors, significant private company investments of directors, associate or joint venture companies, key personnel and significant investors (20%).
 - Ensure that the permanent file is updated for related parties.
 - If it is the first year of the audit perform company search; otherwise review statutory records to confirm directorships, other directorships and significant investors.
 - Discuss the list of related parties as disclosed by the directors as to its accuracy and completeness.
 - Enquire of directors as to whether there have been any material transactions with the related party, for example loans, purchase or sale of assets, consultancy fees etc.
 - List all transactions disclosed by the directors.
 - Review the accounting records before and after the year end for any large or

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round sum amounts; investigate and analyse with reasons.

- Review board minutes and enquire as to whether the company has provided any guarantees.
- Analyse the details of guarantees given and review the terms.
- Include confirmation of all related party transactions or lack of them within the letter of representation.
- Check the accuracy of disclosure within the context of AS 18.

3. Audit Planning

Circumstances	Why taken into account	Effect on audit approach
This is a new audit client	(i) Lack of cumulative/prior knowledge, from which assurance can be derived, increases inherent risk. (ii) Adequate planning is essential for audit efficiency to prevent over-auditing in first year.	(i) Accounting systems and internal controls need to be ascertained. Flowcharting will probably be appropriate. (ii) Current period audit work should have regard to the opening balances to provide assurance as to the accuracy of the opening position
The accounts of each division are not being reported on individually.	Materiality, risk, the audit approach and extent of audit procedures must be assessed in the context of the company ('consolidated') accounts.	Sample sizes should be apportioned between divisions (e.g. by stratifying populations to divisions) to curb tendency to over audit.
The company operates from five locations	Assets which are material to the balance sheet (inventory and possibly premises, equipment, fixtures, etc.) are kept at five different locations.	The year end attendance at inventory counts should cover all locations and take the opportunity to verify other assets, including tangible non-current assets and cash.
Cash sales are made to individuals	Increases the risk of misappropriation of cash and understatement of sales.	(i) Controls over cash must be evaluated and any weaknesses reported to management. (ii) Audit effort should be directed to confirming the completeness of recorded

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		sales for parts and accessories, and workshop in particular.
Computerised inventory information includes dates of movements, cost and selling price relevant to determining the adequacy of inventory provisions.	Computerised inventory records should be materially accurate and up-to-date (otherwise they would not be appropriate for raising purchase requisitions).	<p>(i) If there are no significant differences between physical and book inventories</p> <ul style="list-style-type: none"> - Reliance may be placed on the accuracy of accounting entries to inventory records. - Annual count need not be confined to year end as 'roll-forward' is possible. - Continuous inventory checking may be facilitated. <p>(ii) Audit software may be used to produce an inventory ageing and report by exception.</p> <ul style="list-style-type: none"> - Slow-moving items (e.g. no movements in x months) - Actual selling price less than original purchase price.
Standard mark-ups are used	Standard marks-ups facilitate budgetary control of divisional activities	Analytical procedures including 'proof in total' may confirm the completeness (or otherwise) of recorded revenue.
Parts transferred to workshops are charged at cost plus 10%	<p>(i) Divisional trading at lower mark-ups gives incentive to interdivisional trading and could.</p> <ul style="list-style-type: none"> - Distort GP% subjected to analytical procedures. - Conceal parts sales at more than the allowed 	(i) Inter-divisional trading should separately identified.

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	margin. (ii) Value of parts inventories held by workshop is inflated by 10% unrealised profit	(ii) Although this is unlikely to be sufficiently material to warrant a year end adjustment, consideration should be given to the level of parts inventories held in the workshops. Quantities should be sufficient (to meet most immediate requirements) but not excessive (giving rise to risk of damage/theft)
Sales are made under franchise agreements with each manufacturer	A breach of franchise terms and conditions e.g. concerning prescribed mark-ups) could bring penalty clauses into effects.	(i) This aspect of inherent risk must be assessed. e.g. <ul style="list-style-type: none"> - If low, there may be no implications for the financial statements (e.g. any contingent liability may be disregarded as being remote) - If high (see also management bias) a provision for penalties could be required. (ii) The appropriateness of the going concern assumption should be considered in the light of <ul style="list-style-type: none"> - Any known breaches - Foreseeable renewals.
Monthly accounts and returns are prepared	These indicate a control conscious head office to mitigate the inherent risk attributable to divisional operations.	(i) The disaggregated financial information (by divisions and certain activities) should highlight key audit areas and fluctuations requiring investigation. (ii) For analytical procedures on the company's 'consolidated' accounts, the inter-divisional trading and balances must be

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		eliminated.
Divisional managers have profit-related bonus incentives.	<p>Inherent risk is increased by possible management bias to overstate profit by</p> <ul style="list-style-type: none"> - Overstating sales - Understating expenses 	<p>(i) This bias may reduce other aspects of inherent risk (e.g. of loss of cash/inventory through unrecorded sales)</p> <p>(ii) Risk of sales overstatement may not be great, since</p> <ul style="list-style-type: none"> - Maximum prices set by franchise agreement, and - Market is fiercely competitive at present time. <p>(iii) Risk of expense understatement is restricted (e.g. because head office controls payroll expenditure)</p> <p>(iv) Audit tests should be directed to most likely area of misstatement (e.g. 'errors' arising through suppression of invoices.</p>

4. (a) Supervisor's assumptions

Objectives and limitations

Due to inherent limitations (including human error/misunderstanding, collusion and override), an internal control system can only provide reasonable confidence that internal control objectives (including completeness, accuracy and validity) are met.

(i) Completeness

To ensure that all workers who should be paid are included on the payroll:

- Payroll expense could be reconciled to production output records, and
- Management could review exception reports of employees having personnel records but not included on the payroll.

However, **Cost/benefit** i.e. the expense of setting up computerised personnel records may outweigh the benefit to the company. (Risk is of over payment as employees entitled to pay are likely to bring non-payment to management's attention promptly)

Changes in conditions

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A reduction in the ratio of production to support staff may limit the usefulness of production output records as a basis of comparison.

(ii) **Accuracy**

To prevent errors in payroll deductions:

- Calculations of PAYE, NICs etc. can be checked prior to processing and
- Non-statutory deductions (e.g. pension contributions, union subscriptions) should require prior authorisation in writing.

However, **Human error/misunderstanding** i.e. errors in deductions may not be detected, due to fatigue, distraction, misjudgment or misinterpretation.

Non-routing transactions

Systematic checking procedure may be directed at routing deductions (e.g. PAYE) rather than non-routing transactions) e.g. give as you earn, maintenance payments)

(iii) **Validity**

To ensure that employee are only paid for work done

- Hours worked per time sheets(or clock cards) can be approved by a departmental manager (or-supervisor), and
- The duties of payroll preparation and payment should be segregated.

However, **Abuse or override** i.e. authorisation could be given for a new employee to be added to the payroll without the proper checks being carried out by the authoriser.

Collusion

The person responsible for paying wages could collude with the person responsible for accounting for wages to perpetrate and conceal a theft of wages.

(b) **Internal control terminology**

(i) **Segregation of duties**

Meaning: Segregation of duties is a factor reflected in the control environment (the overall attitude, awareness and actions of management regarding internal controls in the entity).

If one person has responsibility for the recording and processing of a complete transaction, he may also have the power to falsify the records or to misappropriate money or assets without being discovered.

Separation of these responsibilities will reduce the risk of intentional or unintentional errors occurring.

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The functions that should normally be separated include authorisation, execution, custody and recording.

Example

- Calculation of PAYE and NIC deductions should be reviewed and authorised by the payroll supervisor who is not actually involved in performing the calculations.
- Unclaimed wages should be kept by someone (e.g. the cashier) other than the person responsible for recording payroll entries, otherwise there could be a temptation to falsify the figures and pocket some of the wage.

(ii) Approval and control of documents

Meaning: Approval and control of documents is a specific control procedure (aimed at preventing or detecting and correcting errors)

Approval is concerned with ensuring that transactions are properly authorised prior to execution.

Control of documents is aimed at ensuring that all, and only valid transactions, are promptly recorded.

Example

- Overtime pay should be approved by manager or director prior to payroll preparation, to ensure that employees are paid at authorised rates.
- Clock cards should be batched and control totals established (e.g. number of cards, total hours worked, hash total of employee number) prior to submission to payroll department, to prevent (or detect for early investigation) any omissions (or unauthorised insertions)
- The numerical sequence of forms for new joiners should be checked periodically to detect omissions (or unauthorised insertions).

5. (a) A key feature of the accounting software package used by the company definitely involves the absence of a clear audit trail. In other words, transactions cannot be easily traced or co-related from the individual supporting documents of those transactions. Moreover, the management does not wish to print the daybooks in view of the voluminous nature since it may involve extensive costs. This has naturally led to extensive dependence by management upon the "exception reporting" principle.

From the auditor's point of view, it must also be conceded, the exception reports in the form of 'query-based reports' which isolate the above data provide him with the very material that he requires for most of his verification work. The only problem which it raises, and it is a serious one, is that he cannot simply assume that the programmes which produce the exception reports are reliable in respect of the

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following factors:

- (i) operating accurately;
- (ii) printing out all the exceptions which exist; and
- (iii) bound by programmed control parameters which meet the company's genuine internal control requirements.

In view of the above, whether management relies upon exception reports, it effectively eliminated the audit trail between input and output and the auditor is forced to test the invisible processes which purport to embody the controls, and produce the output such as it is. These tests, which invariably involve the use by the auditor of the computer itself, are known as tests through the machine. In the 'through the machine' approach, the auditor starts by proving the accuracy of the input data, and then thoroughly examines (by applying tests) the processing procedures with a view to establishing the following that:

- (i) all input is actually entered into the computer.
- (ii) neither the computer nor the operators can cause undetected irregularities in the final reports.
- (iii) the programmes appear, on the evidence of rejection and exception routines, to be functioning correctly.
- (iv) all operator intervention during processing is logged and scrutinised by the DP manager.

The auditor in such circumstances will have to first evaluate the existing controls. For the same, he has to do the following:

- (i) Evaluate the internal control system especially the controls and checks existing for recording the transactions, i.e., he has to verify at what level transactions can be entered into the system and what checks are available to prevent any unauthorised data entry and for rectifying errors/omissions in the transactions entered.
- (ii) Evaluate at what level there authority is given for modification of transactions already entered. Is there any authority given only to a senior employee to carry out modifications? Or is it that once transactions are entered and validated, no further modifications are possible thereto.
- (iii) Whether there is a provision in the software for carrying out an on line audit of transactions, i.e. whether there a separate module in the package, where a separate password given to the auditor and once he has seen and approved a particular transaction/set of transactions, the same would be locked and no modifications would be possible by anyone (including the senior most employee) in the company.
- (iv) Whether there are proper procedures for backup of data on a regular basis and whether the said procedures are being strictly followed.

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- (v) In case of any loss of data whether there is a clear defined recovery procedure to minimize the loss of data due to power failures or any human errors.
- (vi) The auditor may introduce some dummy data into the system and see the results obtained.

After the auditor has evaluated the above procedures, he has to prepare an audit plan depending on the results obtained from his earlier evaluation. Since the daybooks are not being printed, the plan can contain procedures wherein data is verified directly on the computer from the vouchers/invoices, etc. The audit plan will also require a lot of analytical procedures to be performed. Depending on the importance of various expense heads and other important account heads, the auditor will also obtain various reports from the system depending on various queries that he would have to identify. Some illustrative reports can be:

- (i) To check whether proper classification is done for revenue/capital - a report can be obtained of all purchases (not being raw materials or other routine purchases) exceeding ₹ one lakh.
- (ii) To check whether all freight outward bills are accounted for a report containing a month-wise co-relation between goods despatched and freight amount paid. The same can be further co-related with the freight rates obtained from the bills.

Once the auditor has performed the above procedures, he would be able to form an opinion whether reliance can be placed on the accounting systems and the data recorded. If the auditor finds that reliance cannot be placed on the systems he can inform the management about the fact and also that the daybooks, etc., will need to be printed to allow him to conduct the audit. The finalisation procedures to be followed even under this system would remain more or less similar to other accounting systems. The auditor can obtain reports of depreciation on fixed assets, inventory valuation and using the normal procedures find out whether reliance can be placed on them, e.g., if while valuing stocks the system is using the LIFO method, the same would not be acceptable and will need to be modified. Similarly depreciation calculations will have to be verified on a random basis to find out its reliability.

- (b) The reliability of a component is a function of control that acts on the component. In a computer system the following are the major types of controls are used to enhance component reliability which the auditor must evaluate:
 - (i) **Authenticity Control:** They are exercised to verify the identity of the individuals or process involved in a system. (Pass word, digital signature etc.)
 - (ii) **Accuracy Control:** These attempts to ensure the correctness of the data and processes in a system (Programme validation check).
 - (iii) **Completeness Control:** This ensures that no data is missing and all processing is carried through to its proper conclusion.
 - (iv) **Privacy Control:** This ensures the protection of data from inadvertent or

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unauthorised disclosure.

- (v) **Audit Trail Controls:** This ensures the traceability of all events occurred in a system.
 - (vi) **Redundancy Control:** It ensures that processing of data is done only once.
 - (vii) **Existence Control:** It attempts to ensure the on going availability of all system resources.
 - (viii) **Asset safeguarding controls:** It attempts to ensure that all resources within a system are protected from destruction or corruption.
 - (ix) **Effectiveness Control:** It attempts to ensure that the system achieves its goals.
 - (x) **Efficiency Control:** It attempts to ensure that a system uses minimum resources to achieve its goals.
6. (a) Accounting Standard (AS) 13, 'Accounting for Investments', states that 'the cost of an investment includes acquisition charges such as brokerage fees and duties'. Keeping in view the nature of the items of acquisition charges mentioned in AS 13, the cost of acquisition should include only those direct charges which are incurred 'on' acquisition of investment, i.e. the expenses, without the incurrence of which, the transaction could not have taken place such as share transfer fees, stamp duty, registration fees, and duties and levies by regulatory agencies and stock exchanges. The expenses incurred 'before' the acquisition, even though directly attributable to acquisition should not be added to the cost of acquisition of shares as these do not represent the worth of the shares acquired.
- (i) Keeping in view the above principles, in the present case, travelling cost and due diligence cost should not form part of the cost of acquisition; rather, these should be expensed in the period in which these are incurred. The legal costs and 'other expenses' should form part of the cost of investment only if and only to the extent these costs meet the considerations for inclusion in the cost of investment as stated above.
 - (ii) The exchange loss incurred by the Indian company on account of sending and receiving back excess US\$ from its Malaysian subsidiary cannot be treated as part of the cost of the investment as these expenses do not represent the worth of the shares acquired.
- (b) (i) All the proposals of the company are legally valid. Profit of ₹ 17,00,000 after tax and depreciation is the profit contemplated in Section 205(2A) of the Companies Act as clarified by the Company Law Board. Reserve on account of shipping reserve of ₹ 3,00,000 is an item of prior deduction for determination of the figure of ₹ 17,00,000 on this account. Since the company is proposing a transfer to reserve of 10% of the current profit, there is no problem before the company for declaration of dividend. Under Section 205(2A) of the Companies Act, a transfer not exceeding 10% of the current profits to reserve

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is required and the question of voluntary higher transfer will arise only if the rate of transfer is higher than 10%. The Companies (Transfer of Profit to Reserve) Rules, 1975 issued under Section 205(2A) of the Companies Act provide for a transfer to reserve of "not less than 5% of the current profits" in respect of the dividend rate exceeding 12.5% but not exceeding 15%. Thereafter transfer to reserve of 5% more up to 10% is valid. As per the clarification of the Company Law Board, fixed preference dividend is not to be considered in Section 205(2A) of the Companies Act, 1956.

- (ii) The proposal is not legally sustainable.

It is a case of voluntary transfer to reserves at a percentage higher than 10% under Section 205(2A) of the Companies Act, 1956. Any voluntary transfer of profits of a percentage higher than 10% to reserve can be made only when the company complies with the requirements laid down by the Companies (Transfer of Profits to Reserve) Rules. When a company declares a dividend and wishes to transfer profit to reserve at a percentage higher than 10%, it is incumbent on it to at least maintain the average rate of dividend declared by the company in respect of the immediately preceding three years. In the present case the average rate of dividend works out to 13%. The dividend proposed in 2009-10, viz. 11% is less than this rate and, therefore the company cannot make a transfer of a higher percentage reserves than 10%. It should also be noted that the company's post-tax profit is not less than the average post-tax profit for the last two years and no bonus shares have been issued by the company during 2009-10 or in the preceding three years which would have permitted transfer to reserves higher than 10% with a reduced rate of dividend.

- (iii) Yes, the company's proposal to transfer to reserves @ 20% would be in order in view of the fact that the current year's rate of proposed dividend is higher than the average rate of dividend for the preceding three years.
- (iv) Yes, the company's post-tax profit for the year is less than the average post-tax profit of the company for the preceding two years by more than 20%. The post-tax profit for the year is ₹10,00,000 whereas the average post tax profit, taking 2008-2009 and 2007-2008 figure into account is ₹16,00,000; the former is less than the latter by about 37.5%. Since the current year's post-tax profits is less by 37.5% than the average post-tax profit referred to above, the company is free to make voluntary transfer to reserves at more than 10% without being required to maintain the rate of dividend, as per the Companies (Transfer of Profits to Reserve) Rule, 1975.

Therefore, the company's proposal to pay dividend @11% and transfer to reserve @20% would be valid propositions.

- (v) The proposal is in conformity with law. The company has issued bonus shares within the preceding three years and therefore, it is required to maintain the

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amount of dividend for 2009-10 at least at the level of the average of the amounts paid during the preceding three years. The average aforesaid works out to ₹ 10,53,333. The current years proposed amount, ₹ 8, 00,000 is less than the aforesaid average figure. Therefore, on the first-count the company cannot make transfer of ₹ 2 lakhs to reserves. However, compared to the average of corresponding profits to the preceding two years, the profit is 2009-10 is lower by more than 20%; therefore, the company is allowed to pay a lower dividend. Because of this overriding situation the company is not obliged to maintain the average amount of dividend as contemplated in a situation where bonus shares have been issued.

7. (a) Schedule VI to the Companies Act, 1956 was amended in 1996 to show separately "Balance of unutilised monies raised by issue" under the heading of Investments with the aim to ensure that the money is invested properly till it is used for the purpose for which it was raised. Accordingly, a requirement was also included in the Schedule VI as under:

"All unutilised monies out of the issue must be separately disclosed in the Balance Sheet of the company indicating the form in which unutilised funds have been invested."

Schedule VI to the Companies Act, 1956 also requires specific disclosure of loans granted by the company to its directors or parties such as firms or private companies in which director is a member or a director or a member. Thus, the company has failed to comply with the requirements of schedule VI vitiating true and fair view.

Further, the Companies Act, 1956 specifically deals with transactions in which particular directors are interested. Section 297 specifies that Board's consent is required for certain contracts in which particular directors are interested i.e. a director of the company or his relative, a firm in which such a director or relative is a partner, any other partner in such a firm, or a private company of which the director is a member or director, for the sale, purchase or supply of any goods, materials or services. Section 299 requires disclosure of interest by a director as also lays down the procedure to be followed in this regard. Section 301 of the Companies Act, 1956 requires that every company shall keep one or more registers in which shall be entered separately particulars of all contracts or arrangements to which Section 297 or Section 299 applies, including the following particulars to the extent they are applicable in each case, namely:

- (i) the date of the contract or arrangement;
- (ii) the names of the parties thereto;
- (iii) the principal terms and conditions thereof;
- (iv) in the case of a contract to which Section 297 applies or in the case of a contract or arrangement to which sub-section (2) of Section 299 applies, the

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date on which it was placed before the Board;

- (v) the names of the directors voting for and against the contract or arrangement and the names of those remaining neutral.

Thus, it is quite natural that all these particulars should have been recorded in such registers since the company advanced monies to various parties "related" to directors.

Still further, CARO, 2003 specifically requires the auditor to comment on the rate of interest and other terms and conditions of loans granted by the company (whether secured or unsecured) to companies, firms or other parties listed in the register maintained under Section 301 of the Act. There may be situations where the company has not properly maintained the register required to be maintained by it under Section 301. In such a case, the auditor should obtain the necessary information regarding the loans taken by the company from companies, firms or other parties in which the directors are interested, from the management of the company. However, while reporting on this clause, the auditor is required to clearly mention the fact of non-maintenance/improper maintenance of the aforesaid register. The auditor's duty is to determine whether, in his opinion, the rate of interest and other terms and conditions of the loans are prima facie prejudicial to the interest of the company.

The aforesaid provisions aim to prevent siphoning off of funds as also exercise propriety in case of transactions with related parties and disclosure of the same. It appears that the auditor did not perform his duties properly. In the case of Deputy Secretary of the Government of India, Ministry of Finance vs. S.N. Dasgupta, the learned judge made certain observation as regards the duties of the auditor and method they should follow for discharging them satisfactorily and stated that, "verifying not merely the arithmetical accuracy of the statements of account but also their substantial accuracy by confirming that they include all the particulars requiring disclosure by the Articles or the Companies Act and otherwise represents true and fair state of affairs of the company."

Therefore, the auditor has specific obligation to report under the Companies Act, 1956. Thus, he is liable under the Companies Act, 1956 and may be penalised under section 233 since he has performed his duties in a negligent manner. The auditor would also be held liable for professional misconduct under clause 7 of Second Schedule to the Chartered Accountants Act, 1949.

- (b) **Auditor's liability in case of unlawful Acts or defaults by clients:** The auditor's basic responsibility is to report whether in his opinion the accounts show a true and fair view and in discharging his responsibility he has to see as to how the particular situations affected his position. The general thinking with regard to unlawful acts or defaults by clients appears to be that the auditor should not 'aid or abet' but he is apparently not under any legal obligation to disclose the offence. A professional accountant would himself be guilty of a criminal offence if he advises his client to

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commit any criminal offence or helps or encourages in planning or execution of the same or conceals or destroys evidence to obstruct the course of public justice or positively assists his client in evading prosecution. A professional accountant in his capacity as auditor, accountant, or tax representative has access to a variety of information concerning his clients. On some occasions, he may acquire knowledge that his client has been guilty of some unlawful act, default, fraud, or other criminal offence. The duty of the professional accountant in such a case would depend upon the actual circumstances of the situation. Due consideration should be given to the exact nature of services that a professional accountant is rendering to his client, i.e. is he representing the client in income-tax proceedings or is he acting in the capacity of an auditor or an accountant or a consultant.

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

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

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

It has been clearly established in various case laws that the auditor is expected to know the contents of documents and records and ascertain whether the affairs of the client are being conducted in an unlawful manner. It is in the course of the work, he comes across any unlawful acts, it is his duty to bring it to the notice of the client

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as also to make a disclosure in his report in appropriate cases. In this regard, one has to bear in mind the consequence of the act in relation to the professional code to which an auditor is subjected. Under the Code of Ethics, an auditor cannot disclose confidential information unless permitted by the client or unless required by law. Each case has to be judged on its circumstances. However, in every case he has to assess the implications of the unlawful act or default on the true and fair character of the accounting statements.

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

8. Auditor's responsibilities in cases where audit report for an earlier year is qualified is given in SA 710 "**Comparative Information – Corresponding Figures and Comparative Financial Statements**". As per SA 710, When the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.

SA 710 further states that if the auditor's report on the prior period, as previously issued, included a qualified opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

- (a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
- (b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

In the instant Case, if P Ltd. does not make provision for doubtful debts the auditor will have to modify his report for both current and previous year's figures as mentioned above. If however, the provision is made, the auditor need not refer to the earlier year's modification.

9. (a) Para 4(xv) of CARO, 2003 requires the auditor to state in his report whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and condition whereof are prejudicial to the interests of the company. The auditor should examine the Memorandum of Association to determine whether the company has the power to give guarantee. The auditor should also

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examine the minute book and register of guarantee to ascertain whether guarantee has been issued under the sanction of competent authority. The auditor should also verify compliance with requirements of sections 295 and 372A of the Companies Act, 1956. It should also be ensured that the guarantee given is shown as contingent liability.

In determining whether the guarantee is prejudicial to the interest of the company, the auditor should consider financial standing of the party, nature of security offered, etc. In this case, since financial condition of the company on behalf of whom guarantee is given is not so good, the auditor may consider expressing an opinion that the terms and conditions on which the company has given guarantees for loans taken by the sister concern, i.e., M/s B Ltd., is prejudicial to the interests of the company.

- (b) Para 4(ii)(a) of CARO, 2003 requires the auditor to state in his report whether physical verification of inventory has been conducted at reasonable interval by the management. Physical verification of inventory is the responsibility of the management which should verify all material items at least once in a year and more often in appropriate cases. The auditor in order to satisfy himself about verification at reasonable intervals should examine the adequacy of evidence and record of verification. In the given case, the above requirement of CARO, 2003 has not been fulfilled as such and the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable. He may consider the impact on financial statement and report accordingly.
- (c) Para 4(x) of CARO, 2003 requires the auditor to state in his report in respect of a company which is in existence for more than 5 years from the date of registration:
 - (a) whether the accumulated losses at the end of the year are more than 50% of its net worth; and
 - (b) whether it has incurred cash losses during the current year and the immediately preceding financial year.

In the instant case, since the company is covered by the above requirements, there are symptoms of potential sickness and, thus, auditor should report the same. It is, however, to be assumed that the company is in existence for more than 5 years.

10. (a) Section 292A was inserted by the Companies (Amendment) Act, 1998 providing for constitution of audit committees by public companies having paid-up capital of not less than ₹ five crores. On the other hand, the Clause 49 was introduced by the SEBI requiring listed entities to comply with audit committee requirements in a phased manner, Clause 49 requires obtaining a certificate from auditors of the entity as regards compliance of conditions of corporate governance specified in the said clause. Though there are differences as to composition of the committee under both these requirements, however, significant additional requirements which are stipulated as per Section 292A of the Companies Act, 1956 and silent in Clause 49 of the Listing Agreement are as under:

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- (i) The audit committee constituted shall act in accordance with terms of reference to be specified in writing by the Board.
 - (ii) The recommendations of the audit committee on any matter relating to financial management, including the audit report shall be binding on the Board.
 - (iii) If the Board does not accept the recommendations of the audit committee, it shall record the reasons thereof and communicate such reasons to the shareholders.
- (b) Constitution and Functions of Audit Committee: Section 292A of the Companies Act, 1956 requires that every public company having not less than ₹ 5 crores of paid up capital shall constitute a committee of Board known as Audit Committee. It shall consist of not less than three directors and such number of other Directors as the Board may determine of which two-third shall be directors other than the Managing Director and whole time director. They shall elect one such member amongst them as Chairman. The auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the Audit Committee but shall not have the right to vote.

Every audit committee constituted as above shall act in accordance with the terms of reference specified in writing by a Board. The function of the audit committee as specified in the Companies Act, 1956 are as under:

- (i) The Audit Committee should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review the half-yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems.
- (ii) The Audit Committee shall have authority to investigate into any matter in relation to the items specified in this section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary.

11. (a) Permanent Consolidation Adjustments - Permanent consolidation adjustments are those adjustments that are made only on the first occasion of the preparation and presentation of consolidated financial statements. Permanent consolidation adjustments are:

- (i) determination of excess or deficit of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made (determination of goodwill or capital reserve);
- (ii) determination of the amount of equity attributable to minorities at the date on which investment in subsidiary is made; and
- (iii) determination of goodwill or capital reserve arising on application of equity method to account for investments in associates in consolidated financial

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statements.

The auditor should verify that the above calculations have been made appropriately. The auditor should pay particular attention to the determination of pre-acquisition reserves of the subsidiary and associates. Date(s) of investment in subsidiary and associates assumes importance in this regard. The auditor should also examine whether the pre-acquisition reserves have been allocated appropriately between the parent and the minorities of the subsidiary. The auditor should also verify the changes that might have taken place in these permanent adjustments on account of subsequent acquisition of shares in the subsidiary/ associates, disposal of the subsidiary/associate in the subsequent years. The auditor should also examine the joint venture agreements, to establish whether any change has taken place in the interest of the parent in the joint venture.

It may happen that in the case of one subsidiary, goodwill arises and in the case of another subsidiary a capital reserve arises. The parent may choose to net off these amounts to disclose a single amount in the consolidated balance sheet. In such cases, the auditor should verify that the gross amounts of goodwill and capital reserves arising on acquisition of various subsidiaries have been disclosed in the notes to the consolidated financial statements to reflect the excess/shortage over the parents' portion of the subsidiary's equity.

- (b) Following are the current period consolidation adjustments while making consolidation of financial statements.
- Elimination of intra-group transactions relating to interest or management fees etc.
 - Elimination of unrealized intra-group profits on assets acquired from other subsidiaries.
 - Elimination of intra-group indebtedness.
 - Adjustments for harmonizing different accounting policies of parent unit and its subsidiaries.
 - Adjustments for impairment loss that might exist for goodwill.
 - Adjustment for significant events that occur between date of financial statements of the parent and of its components when the date/s of financial statements of components are different from the reporting date.
 - Determination of movement in equity attributable to the minorities since the date of acquisition of the subsidiary.
 - Treatment of minority interests' share of the losses, if such losses exceed the minority interests' share in the equity.

12. (a) (1) Advances to DOT COM Companies

- (i) Evaluate the efficacy of internal control system in general to ascertain

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whether an advance is made only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank. The sanction for an advance must specify, among other things, the limit of borrowing, nature of security, margin to be kept, interest, terms of repayment, etc. Also see that all the necessary documents, e.g., agreements, demand promissory notes, letters of hypothecation, etc. have been executed by the parties before advances are made.

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

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the amount outstanding in the advance.

- (ix) Ensure that proper provisioning norms have been applied in view of non-observance of terms, coupled with irregular payment of interest and default in repayment of instalments, if any.

(2) Balances in Account of a Bank situated in a Foreign Country

- (i) Verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at the year-end.
 - (ii) Review the reconciliation statements and pay particular attention to the following.
 - (1) Examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to revenue for the year have been so taken. This should be particularly observed when the bills collected, etc., are credited with net amount and entries for commission, etc. are not made separately in the statement of account.
 - (2) Examine that no cheque sent or received in clearing is outstanding. As per the practice prevalent among banks, any cheques returned unpaid are accounted for on the same day on which they were sent in clearing or on the following day.
 - (3) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.
 - (iii) Examine the large transactions in inter-bank accounts, particularly towards the year-end, to ensure that no transactions have been put through for window-dressing.
 - (iv) Check original deposit receipts in respect of balances in deposit accounts in addition to confirmation certificates obtained from banks in respect of outstanding deposits.
 - (v) Check whether these balances are converted into the Indian currency at the exchange rates prevailing on the balance sheet date and ensure compliance with AS 11 on "The Effects of Changes in Foreign Exchange Rates".
- (b)** The items to be covered in the current audit of advances of a bank are as follows:
- (i) Ensure that loans and advances are sanctioned properly.
 - (ii) Verify whether the sanctions are in accordance with the delegated authority.
 - (iii) Ensure that securities and documents have been received and properly charged/registered.
 - (iv) Ensure that post disbursement supervision and follow up is proper.

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- (v) Verify whether there is any misuse of loans and advances and whether there are instances indicative of diversion of funds.
- (vi) Check whether letters of credit issued by the branch are within the delegated power and ensure that they are genuine trade transactions.
- (vii) Check bank guarantees issued are properly worked and recorded.
- (viii) Ensure proper follow up of over due bills of exchange.
- (ix) Verify the classifications of advances are as per RBI directions.
- (x) Verify whether the submission of claims to DICGC and ECGC is in time.
- (xi) Verify the instances of exceeding delegated powers have been promptly reported.
- (xii) Verify the frequency and genuineness of such exercise of authority beyond to delegated powers of the concerned officials.

- 13. Audit of Receipts and Payments Account:** Section 11(1A) of the Insurance Act, 1938 provides that every insurer, in respect of insurance business transacted by him and in respect of his shareholders' funds, should prepare at the end of each financial year, a Balance Sheet, a Profit and Loss Account, a separate account of receipts and payments and a Revenue Account in accordance with the Regulations made by the IRDA. Since receipts and payments account has been made a part of financial statements of an insurer, it is implied that the receipts and payments account is also required to be audited.

The IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002 require that the auditor of an insurance company should:

- (i) report whether the receipts and payments account of the insurer is in agreement with the books of account and returns;
- (ii) express an opinion as to whether the receipts and payments account has been prepared in accordance with the provisions of the relevant statutes; and
- (iii) express an opinion whether the receipts and payments account give a true and fair view of the receipts and payments of the insurer for the financial year/period under audit.

It may hence be said that auditor is required to audit the Receipts and Payments Account of the insurer and also express an opinion on the same.

- 14. (a) 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.
- (b) Compliance with provisions of the Act and Rules:** An auditor of a co-operative society is required to point out the infringement with the provisions of the relevant

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Co-operative Act Rules and bye-laws. The auditor of a co-operative society is also required to point out various irregularities, improprieties, and departure from the provision of the Act, rules framed thereunder and the bye-laws of the society. The financial implications of such infringements should be properly assessed and quantified by the auditor and they should be reported. Some of the State laws contain restrictions on the payment of dividends, which should be noted by the auditor and if dividend is declared in excess of the prescribed percentage, the fact should be reported by the auditor. Auditor should also ensure that various provisions in the Co-operative Societies Act, such as, restriction on borrowings, investment of funds, contribution to education funds, restriction on loans, etc are also complied with.

(c) **Special Report to the Registrar** The auditors are required to report on number of matters as prescribed in various states. In addition to the main report, the auditors are also required to submit by way of schedules/audit memorandum information on the working of the company as well. 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.
- (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.

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

When a chartered accountant is appointed to conduct a tax audit u/s 44AB of the Income -tax Act, 1961, his appointment is not under the Companies Act, 1956 but under the Income-tax Act, 1961. In the Income-tax Act, 1961 there is no such provision for a person to be disqualified on his becoming indebted to the company.

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Thus in the instant case, though the entire audit fees are taken in advance, Mr X would still be able to carry out the audit and he would not be disqualified. However, having regard to be professional ethics in general an auditor must avoid such situations and may consider disclosing the same.

- (b) The change in the method of valuation of stock is not a change in method of accounting, as it is only a change in accounting policy. However in the Income-tax Act, 1961 this is considered under method of accounting. Under the Income-tax Act, 1961, if the change in method of valuation is bonafide, and is regularly and consistently adopted in the subsequent years as well, such change would be permitted to be made for tax purposes. In the instant case, the change in the valuation of stock from LIFO basis to FIFO basis is pursuant to mandatory requirements of the AS 2 'Valuation of Inventories' and therefore should be viewed as bonafide change.

This apart, the tax auditor in his report has to specifically refer to the method of valuation of stock under Clause 12 in Form 3CD.

- (a) Method of valuation of closing stock employed in the previous year.
(b) Details of deviation, if any, from the method of valuation prescribed under section 145A and the effect thereof on profit or loss.

The auditor has to see that the method of stock valuation is followed consistency from year to year. It is also necessary to ensure that method followed for valuation of stock results in correct profits or gain. The change from LIFO to FIFO is bonafide, the disclosure of which would have to be made in the financial statements. As far as section 145A is concerned, the tax auditor need not change the method of valuation of purchases, sales and inventories which is regularly employed by the assessee. All that he has to do is to adjust the valuation for any tax, duty, cess or fee actually paid or incurred by the assessee, if the same had not already been adjusted.

16. (a) Key functions of Energy Auditor

Energy auditing is defined as an activity that serves the purposes of assessing energy use pattern of a factory or energy consuming equipment and identifying energy saving opportunities. In that context, energy management involves the basic approaches reducing avoidable losses, improving the effectiveness of energy use, and increasing energy use efficiency. The function of an energy auditor could be compared with that of a financial auditor. The energy auditor is normally expected to give recommendations on efficiency improvements leading to monetary benefits and also advise on energy management issues. Generally, energy auditor for the industry is an external party. The following are some of the key functions of the energy auditor:

- (i) Quantify energy costs and quantities
(ii) Correlate trends of production or activity to energy costs
(iii) Devise energy database formats to ensure they depict the correct picture – by

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product, department, consumer, etc.

- (iv) Advise and check the compliance of the organisation for policy and regulation aspects.
- (v) Highlight areas that need attention for detailed investigations.
- (vi) Conduct preliminary and detailed energy audits which should include the following:
 - (a) Data collection and analysis
 - (b) Measurements, mass and energy balances
 - (c) Reviewing energy procurement practices
 - (d) Identification of energy efficiency projects and techno-economic evaluation
 - (e) Establishing action plan including energy saving targets, staffing requirements, implementation time requirements, procurement issues, details and cost estimates.
 - (f) Recommendations on goal setting for energy saving, record keeping, reporting and energy accounting, organisation requirements, communications and public relations.

(b) SEBI's check list for auditors in respect of contract notes issued by a Stock Broker

- (i) Members should issue Contract Notes to his clients for all trades executed by him on their behalf.
- (ii) The member should stamp his order sheets/records and the order time should be reflected in the Contract Note along with the time of execution of order.
- (iii) The Contract Notes should bear SEBI Registration number of the member. It should be pre printed and issued within 24 hours of trade execution. Appropriate stamps should be affixed on the contract Note. Duplicate copies of the contract note should be maintained.
- (iv) The Contract Note should be signed by the member or his constituted attorney.
- (v) Contract note issued to the clients should show the brokerage separately.
- (vi) In case the broker acts as a principal, the Contract Note should be in Form B.
- (vii) Consent of the client should be taken for any trade done by the broker while acting as a principal.
- (viii) Brokerage should be within the limits prescribed by the exchange.

- 17.** Internal auditing is an activity carried out by the internal staff of the organisation to meet the management requirements of information. The definition of internal auditing as given by the Institute of Internal Auditors of New York, in fact, is so wide in its scope that it

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covers both operational and management auditing. According to the Institute of Internal Auditors, "the overall objective of internal auditing is to assist all members of management in the objective discharge of their responsibilities, by furnishing them with objective analysis, appraisals, recommendations and pertinent comments concerning the activities reviewed. The internal auditor, therefore, should be concerned with any phase of business activity wherein he can be of service to organisation". According to the definition, the overall objective of internal auditing is to assist all members of management in the objective discharge of their responsibilities, by furnishing them with objective analysis, appraisals, recommendations and relevant comments concerning the activities reviewed. The internal auditor, therefore, should be concerned with any phase of business activity wherein he can be of service to the organisation. Naturally, when an auditor is concerned with the appraisal of operations, he would be performing the role of an operational auditor. Another important point that this definition throws up is that operational auditing is essentially a function of internal auditing staff. Traditionally, the internal auditing was concerned with the financial transactions only. It was during early 1940's, the concept of operational auditing came into existence. According to Cadmus "operational auditing is not different from internal auditing, it is merely an extension of internal auditing into operational areas. It is characterised in both financial and operational areas – by the auditor's approach and state of mind". The main objective of operational auditing is to verify the fulfillment of plans and sound business requirements as also to focus on objectives and their achievement as against the performance yardsticks evident from in the management objectives, goals and plans, budgets records of past performance, policies and procedures. Industry standards can be obtained from the statistics provided by industry, associations and government sources. It should be appreciated that the standards may be relative depending upon the situation and circumstances; the operational auditor may have to apply them with suitable adjustments. It might appear from the above that an internal auditor is not concerned with operational aspects and operational auditor is, not concerned with financial aspects which is not so. Because traditionally, internal auditors had been engaged in a sort of protective function, deriving their authority from the management. They examined internal controls in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are not there; they checked the accounting books and records to see, whether the internal checks are properly working and the resulting accounting data are reliable. They also looked into the aspect of safety of the assets and properties of the company. Some element of operational auditing could be found even in these traditional functions of internal auditors, specially in the context of fraud, wastage and loss. Internal auditors emboldened by their ability to appraise financial and accounting control gradually started extending their field to cover non-accounting control as well. On the other hand, it should not be assumed, that, since an operational auditor is concerned with the audit of operations and review of operating conditions, he is not concerned with the financial aspects of transaction and controls. A point has already been made that the special expertise acquired by the operational auditor, that enables him to view the controls and operations from the management point of view, can be carried back to his review of the financial areas. In the matter of cash transactions, the operational auditor will look into

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such aspects as the quantum of cash in hand (by relating it to the requirement of cash to be held) carried generally or the use of cash not immediately required. Also he will review the operational control on cash to determine whether maximum possible protection has been given to cash. Similarly, in the audit of stocks, he would have management policy. In pure administrative areas on stock, he will see whether adequate security and insurance arrangements exist for protection of stocks.

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

18. A due diligence audit on behalf of S Ltd. with a view to acquiring the business shall involve following steps:
- (i) **Brief history of the target and background of its promoters** - The accountant should begin the financial due diligence review by looking into the history of the company and the background of the promoters. The details of how the company was set up and who were the original promoters have to be gone into, before verification of financial data in detail. An eye into the history of the target may reveal its turning points, survival strategies adopted by the target from time to time, the market share enjoyed by the target and changes therein, product life cycle and adequacy of resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the target. Broadly, the accountant should make relevant enquiries about the history of target's business products, markets, suppliers, expenses, operations
 - (ii) **Accounting policies** - The accountant should study the accounting policies being followed by the target and ascertain whether any accounting policy is inappropriate. The accountant should also see the effects of the recent changes in the accounting policies. The target might have changed its accounting policies in the recent past keeping in view its intention of offering itself for sale. The overall scope has to be based on the accounting policies adopted by the management. The accountant has to look at the main effect of accounting policies on the overall profitability and their correctness. It is reiterated that the accountant should mainly look at all material changes in Accounting Policies in the period subjected to review very carefully.

The accountant's report should include a summary of significant accounting policies used by the target, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the target are different from those adopted by the acquiring enterprise, the effect of such differences.
 - (iii) **Review of Financial Statements** - Before commencing the review of each of the aspect covered by the financial statements, the accountant should examine whether

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the financial statements of the target have been prepared in accordance with the Statute governing the target, Framework for Preparation and Presentation of the Financial Statements and the relevant Accounting Standards. If not the accountant should record the deviations from the above and consider whether it warrant an inclusion in the final report on due diligence.

After having an overall view of the financial statements, as mentioned in the above paragraphs, the accountant should review the operating results of the target in great detail. It is important to make an evaluation of the profit reported by the target. The reason being the price of the target would be largely based upon its operating results. The accountant should consider the presence of an extraordinary item of income or expense that might have affected the operating results of the target. It is advisable to compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period.

- (iv) **Taxation** - Tax due diligence is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. It is important to check if the company is regular in paying various taxes to the Government. Generally taxes are levied both by the Central Government as well as by the State Government. Further taxes may be direct or indirect. Most of the tax laws require the enterprise to register itself with the government and it is important to check if all necessary registrations have been made. The accountant has to also look at the tax effects of the merger or acquisition.
- (v) **Cash Flow** - A review of historical cash flows and their pattern would reflect the cash generating abilities of the target company and should highlight the major trends. It is important to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time. It is necessary to check if a) Is the company able to honour its commitments to its creditors, to the banks, to government and other stakeholders b) How well is the company able to turn its debtors and stocks c) How well does it deploy its funds d) Are there any funds lying idle or is the company able to reap maximum benefits out of the available funds?
- (vi) **Financial Projections** - The accountant should obtain from the target company the projections for the next five years with detailed assumptions and workings. He should ask the to give projections on optimistic, pessimistic and most likely bases.

Ordinarily, it would be desirable that the accountant evaluates the appropriateness of assumption used in the preparation and presentation of financial projections. If, the accountant is of the opinion that as assumption used by the target is unrealistic, the accountant should consider its impact on the overall valuation of the company. He should offer his comments on all the assumption, highlighting those which, in his opinion are not inappropriate. In case he feels the projections provided by the target are not achievable or aggressive he has to mention this in his report. He should thoroughly check the arithmetic of the calculations made for financial projections.

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(vii) Management and Employees - In the Indian context, the status of work force, staff and employees and their demands is a complex problem. In most of the companies which are available for take over the problem of excess work force is often witnessed. It is important to work out how much of the labour force has to be retained. It is also important to judge the job profile of the administrative and managerial staff to gauge which of these match the requirements of the new incumbents. Due to complex set of labour laws applicable to them, companies often have to face protracted litigation from its workforce and it is important to gauge the likely impact of such litigation.

It is important to see if all employee benefits like Provident Fund (P.F.), Employees State Insurance (E.S.I), Gratuity, leave and Superannuation have been properly paid/ provided for/funded. In case of un-funded Gratuity, an actuarial valuation of the liability has to be obtained from a reputed actuary. The assumptions regarding increase in salaries, interest rate, retirement etc. have to be gone into to see if they are reasonable. It is also necessary to see if the basic salary /wage considered for the valuation is correct and includes all elements subject to payment of Gratuity. In the case of PF, ESI etc. the accountant has to see if all eligible employees have been covered.

It is very important to consider the pay packages of the key employees as this can be a crucial factor in future costs. One has to carefully look at Employees Stock Option Plans; deferred compensation plans; Economic Value Addition and other performance linked pay; sales incentives that have been promised etc. It is also important to identify the key employees who will not continue after the acquisition either because they are not willing to continue or because they are to be transferred to another company within the 'group' of the target company.

(viii) Statutory Compliance - During a due diligence this is one aspect that has to be investigated in detail. It is important therefore, to make a list of laws that are applicable to the entity as well as to make a checklist of compliance required from the company under those laws. If the company has not been regular in its legal compliance it could lead to punitive charges under the law. These may have to be quantified and factored into the financial results of the company.

In addition to the above steps, the following further points have to be seen:

- (i) Reason for sale of business and the effect on turnover and profits due to the exist of the present proprietor.
- (ii) The length of the lease under which business has been operating.
- (iii) The unexpired period of patents if any held by the vendors.
- (iv) The age of managerial staff and prospects of their continuing in service in the new environment; the effect of trained managerial staff learning the organisation in production/sales/administrative and the financial liability to pay terminal benefits/compensation, etc.

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- (v) If bulk sales are to a few limited customers, the profitability should be discounted greatly, because any substantial withdrawal of customers might cause business crashes.
- (vi) A company with a sound financial structure can better withstand the stresses and strains of business. A low debt-equity ratio would indicate an ability to grow through debt financing without raising equity.
- (vii) The cash generated from operations; the need for redeployment of resources and funds needed for repayment of loans become major factors in determining growth potential.
- (viii) The valuation of goodwill if any should be on reasonable basis having regards to all factors mentioned above.

- 19. (a)** (i) Under Section 2(2)(iv) of the Chartered Accountants Act, 1949, "A member of the Institute shall be deemed "to be in practice" when individually or in partnership with Chartered Accountants in practice, he, in consideration of remuneration received or to be received renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice. Pursuant to Section 2(2) (iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services".

The definition of the expression "Management Consultancy and other Services" includes Personnel recruitment and selection. Personnel Recruitment and selection includes, development of human resources including designing and conduct of training programmes, work study, job description, job evaluation and evaluations of work loads. So Mr. Ravi is not guilty of professional misconduct.

- (ii) As per clause 5 of Part I of Second Schedule if a member in practice fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary to make the financial statement not misleading, where he is concerned with that financial statement in a professional capacity, he will be held guilty under clause (5). As per clause 6 of Part I of Second Schedule if he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity, he will be held guilty under clause 6.

In given case, the Chartered Accountant had submitted the statements before the taxation authorities. These statements are based on the data provided by the management of the company. Although the statements prepared were based on incorrect facts and misleading, the Chartered Accountant had only submitted them acting on the instructions of his client as his authorized representative.

Hence the Chartered Accountant would not be held liable for professional misconduct.

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- (iii) Under clause 3 of Part II of second schedule, a Chartered Accountant whether in practice or not is guilty of professional misconduct if he includes in any information, statement, return or form to be submitted to the Institute, Council or any of its committees, Directors (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.

In the instant case X Y & Co. included another Chartered Accountant name as partner in his firm, in his application for empanelment as Auditor of branches of Public Sector Banks submitted to the Institute. In fact such a member was not a partner of the said firm on the date of application. He will be held guilty of professional misconduct.

(b) (a) Letter to finance director Fair Ltd.

Dated

Mr. Jagdish Kumar,
Finance Director
Fair Ltd
India

Sub : Clarification of ethical concerns

Dear Sir,

I have studied your letter dated 19 January 20XX and was impressed by your recognition of potential ethical conflicts that may face us as auditors. You will be pleased to know that our professional guidance extends to all the issues raised. Each issue is dealt with in turn below.

(i) Other services

It is not unusual for audit firms to provide their clients with other professional services, such as tax advice and, provided they have the technical resources to undertake such work, it is not seen to impact on their objectivity when reaching an audit opinion.

The provision of such advice benefits both parties. It enables the auditors to gain a better insight into client systems, while allowing the management to receive a less costly service than by employing someone who is less familiar with their circumstances.

However, giving tax advice to the directors personally, as well as acting for the company, could lead to a conflict of interest. Similarly, a conflict of interest could arise between giving tax advice to the company and our audit work. If such a conflict were to arise we would have to consider which work to decline. It may be that we would need to decline all tax work in order to continue to act as auditor.

Ethical guidance also requires us to monitor the proportion of gross fee

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income (audit or otherwise) we receive from a single client. If this exceeds 15% from a limited company, then our objectivity is considered to be at risk, and we must relinquish that client.

(ii) **Attending board meetings**

On occasions it may be desirable for the auditor to attend board meetings, for example when management representations on audit issues are to be discussed and minuted.

However, as you have indicated in your letter, it would be wholly inappropriate for a member of our firm to have a permanent seat on the board. It is vital that a reader of our audit report can be confident that we conducted our work with absolute independence and objectivity; this would not be possible if it were known that we also held an executive role. As a director we would be helping to make policy decisions for which at a later date we would have responsibility for auditing.

(iii) **Borrowing applications**

The preparation of submissions to the bank creates a potential conflict of interest.

For example, say a client's audit report needs qualifying on the grounds of going *concern*. If the auditor were also involved in a submission to the bank he would be under pressure to avoid such a qualification in view of the adverse effect it would have on any attempt to raise additional finance.

In these circumstances the most likely precaution would be to invite another partner to oversee the borrowing application.

I hope that the above has addressed and clarified your concerns, but if you would like any additional information please do not hesitate to contact me.

Yours sincerely

XXX Co.
Chartered Accountants
Firm's Registration No.
.....
(Signature)
(Name of the Member)
(Designation¹)

Date :

Place :

Acknowledged on behalf of XXX Company by

.....
(Signature)

¹ Partner or proprietor, as the case may be.

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Name and Designation

Date

20. (a) Classification of NBFCs :

NBFCs, normally fall into following categories: 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. Consequent upon to RBI Circular December 6, 2006, companies financing real/physical assets for productive/ economic activity will be classified as Asset Finance Company (AFC) as per the specified criteria. The remaining companies would be continued to be classified as loan/investment companies. In the proposed structure the following categories of NBFCs will emerge:

- (i) Asset Finance Company (AFC)
- (ii) Investment Company
- (iii) Loan Company

Specified Criteria:

- (i) Asset Financed Company would be defined as any company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines.
- (ii) Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising therefrom is not less than 60% of its total assets and total income respectively.

The onus of including only eligible assets for the purpose of classification as Asset Finance Company shall be that of the company concerned.

Mortgage Guarantee Company to be NBFC

As per RBI Notification dated January 15, 2008, a Mortgage Guarantee Company, that is, a company registered with the Bank under the scheme for registration of Mortgage Guarantee Companies notified by the Bank in this regard, will be treated as Non-Banking Financial Company under the provisions of the Act."

Infrastructure Finance Company[IFC] (RBI Circular dated February 12, 2010)

It has now been decided to include fourth category of NBFCs as "Infrastructure Finance Companies"(IFCs).

An IFC is defined as non deposit taking NBFC that fulfills the criteria mentioned below:

- (i) a minimum of 75 per cent of its total assets should be deployed in infrastructure loans as defined in Para 2(viii) of the Non Banking Financial (Non Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;

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- (ii) Net owned funds of ₹ 300 crore or above;
- (iii) minimum credit rating 'A' or equivalent of CRISIL, FITCH, CARE, ICRA or equivalent rating by any other accrediting rating agencies;
- (iv) Capital to Risk Asset Ratio (CRAR) of 15 percent (with a minimum Tier I capital of 10 percent).

Core Investment Companies [CICs] (RBI Circular August 12, 2010)

Core Investment Company means a NBFC carrying on the business of acquisition of shares and securities and which satisfies the following conditions as on the date of the last audited balance sheet:-

- it holds not less than 90% of its Total Assets in the form of investment in equity shares, preference shares, debt or loans in group companies;
- its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its Total Assets.
- it does not trade in its investments in shares, bonds, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;
- it does not carry on any other financial activity referred to in section 45-I(c) and 45-I(f) of the RBI Act, 1934 except investment in bank deposits, money market instruments, government securities, loans and investment in debt issuance of group companies or guarantees issued on behalf of group companies.

The above mentioned categories may further have the following sub-categories depending upon their business functions :

- (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 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) Objectives of Peer Review

- (i) To ensure that members while performing attestation services comply with technical standards issued by the Institute;

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- (ii) To ensure that such a member has in place proper system (including documentation system) for maintaining the quality of attestation services performed by him;
 - (iii) To ensure adherence to various statutory and regulatory requirements and
 - (iv) To enhance the reliance placed by the users of financial statements from economic decision making.
- (c) General principles to be confirmed by Propriety**
- (i) The expenditure is not prima facie more than the occasion demands and that every official exercises the same degree of vigilance in respect of expenditure as a person of ordinary prudence.
 - (ii) That the authority exercises its powers of sanctioning expenditure which will not result in any benefit directly or indirectly to such authority.
 - (iii) That the funds are not utilised for the benefit of a particular person or group of persons and
 - (iv) That, apart from the agreed remuneration or reward, no other revenue is kept open to indirectly benefit the management personnel, employees or others.
- (d) True and Fair Cost of Production:** 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 Cost Audit (Report) Rules, 1996 as amended in 2001, prescribe the rules regarding the cost audit report. The prescribed format of the report contains assertions regarding whether cost accounting records have been properly kept so as to give a true and fair view of the cost of production/ processing/ manufacturing/ mining activities and marketing of the product under reference. It may be noted that unlike in the case of audit of financial statements, the cost auditor does not have to state whether the cost statements reflect a true and fair view. In any case, the true and fair concept is known to us in the context of financial accounts. Based on that knowledge, it may be assumed that the following are the relevant considerations in determining whether the cost of production determined is true and fair:
- (i) Determination of cost following the generally accepted cost accounting principles.
 - (ii) Application of the costing system appropriate to the product.
 - (iii) Materiality.
 - (iv) Consistency in the application of costing system and cost accounting principles.
 - (v) Maintenance of cost records and preparation of cost statements in the prescribed form and having the prescribed contents.
 - (vi) Elimination of material prior-period adjustments.
 - (vii) Abnormal wastes and losses and other unusual transactions being ignored in determination of cost.

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ANNEXURE

LIST OF INSTITUTE'S PUBLICATIONS RELEVANT FOR MAY, 2011 EXAMINATION

The following List of Institute's Publications is relevant for the forthcoming examination i.e. May, 2011. Students may kindly take it into consideration while preparing for the examination.

Final Examination Paper 3 : Advanced Auditing and Professional Ethics

I. Statements

1. Statement on Reporting under Section 227 (1A) of the Companies Act, 1956
<http://220.227.161.86/18799announ10264b.pdf>
2. Statement on the Companies (Auditor's Report) Order, 2003 (2005 Edition)
<http://220.227.161.86/18798announ10264a.pdf>

II. Standards on Auditing (SQC/SA/SRS/SRE/SAE)

S.No	SA	Title of Standard on Auditing	Effective Date
1	SQC 1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements http://220.227.161.86/15366Link1.pdf	April 1, 2009
2	SA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing http://220.227.161.86/18132sa200_rev.pdf	April 1, 2010
3	SA 210	Agreeing the Terms of Audit Engagements http://220.227.161.86/16837sa210revised.pdf	April 1, 2010
4	SA 220	Quality Control for an Audit of Financial Statements http://220.227.161.86/18133sa220_rev.pdf	April 1, 2010
5	SA 230	Audit Documentation http://220.227.161.86/15372Link7_SA230-standard.pdf	April 1, 2009
6	SA 240	The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements http://220.227.161.86/15374Link9_240SA_REVISED.pdf	April 1, 2009
7	SA 250	Consideration of Laws and Regulations in An Audit of Financial Statements http://220.227.161.86/15376Link11_SA250-text.pdf	April 1, 2009
8	SA 260	Communication with Those Charged with Governance http://220.227.161.86/15378Link13_SA%20260-text.pdf	April 1, 2009
9	SA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management http://220.227.161.86/16838sa265.pdf	April 1, 2010

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10	SA 299	Responsibility of Joint Auditors http://220.227.161.86/15379Link14_299SA-AAS12.pdf	April 1, 1996
11	SA 300	Planning an Audit of Financial Statements http://220.227.161.86/15381Link16_300SA_REVISED.pdf	April 1, 2008
12	SA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment http://220.227.161.86/15382Link17_315SA.pdf	April 1, 2008
13	SA 320	Materiality in Planning and Performing an Audit http://220.227.161.86/16839sa320revised.pdf	April 1, 2010
14	SA 330	The Auditor's Responses to Assessed Risks http://220.227.161.86/15384Link19_330SA.pdf	April 1, 2008
15	SA 402	Audit Considerations Relating to an Entity Using a Service Organization http://220.227.161.86/16840sa402revised.pdf	April 1, 2010
16	SA 450	Evaluation of Misstatements Identified during the Audits http://220.227.161.86/16841sa450revised.pdf	April 1, 2010
17	SA 500	Audit Evidence http://icai.org/resource_file/15576sa500revised.pdf	April 1, 2009
18	SA 501	Audit Evidence - Specific Considerations for Selected Items http://220.227.161.86/18134sa501_rev.pdf	April 1, 2010
19	SA 505	External Confirmations http://220.227.161.86/18135sa505_rev.pdf	April 1, 2010
20	SA 510	Initial Audit Engagements-Opening Balances http://220.227.161.86/15390Link25_510text.pdf	April 1, 2010
21	SA 520	Analytical Procedures http://220.227.161.86/18136sa520_rev.pdf	April 1, 2010
22	SA 530	Audit Sampling http://220.227.161.86/15393Link28_530text.pdf	April 1, 2009
23	SA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures http://220.227.161.86/15395Link30_540text.pdf	April 1, 2009
24	SA 550	Related Parties http://220.227.161.86/15397Link32_550text.pdf	April 1, 2010
25	SA 560	Subsequent Events http://220.227.161.86/15399Link34_SA%20560_Standard_OKOK.pdf	April 1, 2009
26	SA 570	Going Concern http://220.227.161.86/15401Link36_SA570-final_standard.pdf	April 1, 2009
27	SA 580	Written Representations http://220.227.161.86/15403Link38_sa580.pdf	April 1, 2009

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

28	SA 600	Using the Work of Another Auditor http://220.227.161.86/18836sa600_aas.pdf	April 1, 2002
29	SA 610	Using the Work of Internal Auditors http://220.227.161.86/16842sa610revised.pdf	April 1, 2010
30	SA 620	Using the Work of an Auditor's Expert http://220.227.161.86/18137sa620_rev.pdf	April 1, 2010
31	SA 700	Forming an Opinion and Reporting on Financial Statements http://220.227.161.86/17874sa700annx1.pdf	April 1, 2011
32	SA 705	Modifications to the Opinion in the Independent Auditor's Report http://220.227.161.86/17875sa705annex2.pdf	April 1, 2011
33	SA 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report http://220.227.161.86/17876sa706annex3.pdf	April 1, 2011
34	SA 710	Comparative Information – Corresponding Figures and Comparative Financial Statements http://220.227.161.86/18793annex1SA710.pdf	April 1, 2011
35	SA 720	The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements http://220.227.161.86/15578sa720ann.pdf	April 1, 2010
36	SA 800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Framework http://220.227.161.86/18794annex2SA800.pdf	April 1, 2011
37	SA 805	Special Considerations-Audits of Single Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement http://220.227.161.86/18795annexure3SA805.pdf	April 1, 2011
38	SA 810	Engagements to Report on Summary Financial Statements http://220.227.161.86/18796annexure4SA810.pdf	April 1, 2011
39	SRE 2400	Engagements to Review Financial Statements http://220.227.161.86/18727annex1200410.pdf	April 1, 2010
40	SRE 2410	Review of Interim Financial Information Performed by the Independent Auditor of the Entity http://220.227.161.86/18728annex2200410.pdf	April 1, 2010
41	SAE 3400	The Examination of Prospective Financial Information http://220.227.161.86/15410Link45_3400SAE-AAS35.pdf	April 1, 2007
42	SRS 4400	Engagements to Perform Agreed Upon Procedures Regarding Financial Information http://220.227.161.86/15411Link46_4400SRS-AAS32.pdf	April 1, 2004
43	SRS 4410	Engagements to Compile Financial Information http://220.227.161.86/15412Link47_4410SRS-AAS31.pdf	April 1, 2004

*Effective date means that the SA is effective for audits of the financial statements for periods beginning on or after the specified date.

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III. Guidance Notes/Study Guide/Monograph

1. Guidance Note on Independence of Auditors.
2. Guidance Note on Audit Reports and Certificates for Special Purposes.
3. Guidance Note on Audit of Fixed Assets.
4. Guidance Note on Audit under Section 44AB of the Income-tax Act (2005 Edition).*
5. Guidance Note on Audit of Abridged Financial Statements.
6. Guidance Note on Audit of Inventories.
7. Guidance note on Audit of Debtors, Loans and Advances.
8. Guidance note on Audit of Investments.
9. Guidance note on Audit of Miscellaneous Expenditure.
10. Guidance Note on Audit of Cash and Bank Balances.
11. Guidance Note on Audit of Liabilities.
12. Guidance Note on Audit of Revenue.
13. Guidance Note on Audit of Expenses.
14. Guidance Note on Sections 227(3)(e) and (f) of the Companies Act, 1956.
15. Guidance Note on Certificate of Corporate Governance **(2006 Edition)**
16. Guidance Note on Computer Assisted Audit Techniques (CAATs).
17. Guidance Note on Audit of Payment of Dividend.
18. Guidance Note on Audit of Capital and Reserves.
19. Guidance Note on Provision for Proposed Dividend.
20. Guidance Note on Auditing of Accounts of Liquidators.
21. Guidance Note on Section 293A of the Companies Act and the Auditor.
22. Guidance Note on Audit of Consolidated Financial Statements.

* Guidance Note on Audit under section 44 AB of the Income-tax Act, 1961 (2005 edition) along with the supplementary guidance note (excluding the portion relating to Fringe Benefit Tax Provisions) published in September, 2006.

* Text of applicable Guidance Notes is available in the Appendices of Volume II of Paper 3 - Advanced Auditing and Professional Ethics (CA Final -New). These can be accessed at http://www.icai.org/post.html?post_id=5778.

** Note : Notifications (in relation to syllabus) issued till 31st October, 2010 will be applicable for May, 2011 Examination.