

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

PART – I : ACADEMIC UPDATE (SIGNIFICANT NOTIFICATIONS AND CIRCULARS)

General Circular No: 15/2011 issued by MCA dated 11-04-2011: Revised procedure for appointment of cost auditor by companies under section 233B of the Companies Act, 1956 - Audit of cost accounts in certain cases –

1. Ministry has reviewed the existing procedure followed by the companies for seeking prior approval of the Central Government for appointment of cost auditor under section 233B(2) of the Companies Act, 1956. In supersession of any earlier order/circular issued in this regard, the revised procedure to be followed by the companies and cost auditor shall be as under:
 - (a) The company required to get its cost records audited under section 233B (1) of the Companies Act, 1956 shall appoint a cost auditor who is a cost accountant as defined in clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 (23 of 1959) and who holds a valid certificate of practice under sub-section (1) of section 6 of that Act and includes a firm of cost accountants.
 - (b) The Audit Committee of the Board shall be the first point of reference regarding the appointment of cost auditors.
 - (c) The Audit Committee shall ensure that the cost auditor is free from any disqualifications as specified under section 233B (5) read with section 224 and sub-section (3) or sub-section (4) of section 226 of the Companies Act, 1956.
 - (d) While a cost auditor shall have prime responsibility to ensure that he does not violate the limits specified under section 224(1-B) of the Companies Act, 1956, the Audit Committee shall also be responsible for such compliance by the cost auditor.
 - (e) The Audit Committee shall obtain a certificate from the cost auditor certifying his/its independence and arm's length relationship with the company.
 - (f) The company shall e-file its application with the Central Government on www.mca.gov.in portal, in the prescribed Form 23C within ninety days from the date of commencement of each financial year, along with the prescribed fee as per the Companies (Fees on Applications) Rules, 1999 as amended from time-to-time and other documents as per existing practice i.e., (i) certified copy of the Board Resolution proposing appointment of the cost auditor; and (ii) copy of the certificate obtained from the cost auditor regarding compliance of section 224(1B) of the Companies Act, 1956.
 - (g) On filing the application, the same shall be deemed to be approved by the Central Government, unless contrary is heard within thirty days from the date of filing such application.

- (h) If within thirty days from the date of filing such application, the Central Government directs the company to re-submit the said application with such additional information or explanation, as may be specified in that direction, the period of thirty days for deemed approval of the Central Government shall be counted from the date of re-submission by the company.
 - (i) After expiry of thirty days, as the case may be, the company shall issue formal letter of appointment to the cost auditor, as approved by the Board.
 - (j) Within thirty days of receipt of formal letter of appointment from the company, the cost auditor shall inform the Central Government in the prescribed form, along with a copy of such appointment. An e-form for the same is being developed and will be notified shortly.
 - (k) The company shall disclose full particulars of the cost auditor, along with the due date and actual date of filing of the cost audit report by the cost auditor, in its Annual Report for each relevant financial year.
 - (l) In those companies where constitution of an Audit Committee of the Board is not required by law, the words "Audit Committee" shall stand substituted by the words "Board of Directors".
2. If a company contravenes any provisions of this circular, the company and every officer thereof who is in default, including the persons referred to in sub-section (6) of section 209 of the Act, shall be punishable as provided under sub-section (2) of section 642 read with sub-sections (5) and (7) of section 209 and sub-section (11) of section 233B of Companies Act, 1956.
3. If default is made by the cost auditor in complying with the aforesaid provisions, he shall be punishable with fine, which may extend to five thousand rupees.
4. The modified procedure contained in this circular shall be effective from the financial year commencing on or after the 1st day of April, 2011.

(Source : <http://www.mca.gov.in>)

General Circular No: 10/2011 issued by MCA dated 04-04-20011: Interpretation of the word "Partnership" for the purpose of Chartered Accountants Act, 1949, Cost and Works Accountants Act, 1959 and Company Secretaries Act, 1980.

The Acts governing the three professional Institutes i.e. ICAI, ICWAI and ICSI define in Section 2 members who are deemed to be in practice. In all the three Acts, there is a provision for a member to be in practice when he is in partnership with certain others. In the case of Chartered Accountants and Cost & Works Accountants, such persons must be member of the same Institute, while in the case of Company Secretaries; it is provided that the partnership could also be with members of such other recognised professions as may be prescribed.

2. At the time of enactment of the three Acts governing the professional Institutes, only one form of partnership existed in India, namely Partnerships under Indian Partnership Act, 1932. Subsequently, Parliament has enacted the Limited Liability Partnerships Act, 2008. Though Limited Liability Partnerships are bodies corporate under Section 3(i) of the LLP Act, the fact that LLPs are basically partnerships may be seen from the definition in Section 2(i) (n) :-

"Limited Liability Partnerships means a partnership formed and registered under this Act. Section 2(i)(q) defines a partner as "any person who becomes a partner in the limited liability partnership in accordance with the Limited Liability Partnership Agreement"

It is thus clear that a Limited Liability Partnership is also a partnership and its members are also partners.

3. The matter of permitting member of ICAI, ICWAI and I ICSI was been examined in this Ministry. Acts governing these professionals were passed at a time when limited liability partnership did not exist. It is also clear from the definitions in the Limited Liability Partnership Act that such entities are also partnerships and their members are also partners. In the context of Section 2 of the Acts governing the professional Institutes, this interpretation is also not repugnant to the context. Accordingly, it is clarified that the words "partnership" wherever occurring in the Chartered Accountants Act, 1949, the Cost and Works Accountants Act, 1959 and the Company Secretaries Act, 1980 shall mutatis mutandis be construed as including those Limited Liability Partnerships where all the other partners are natural persons(individuals). The word "partner" shall also be construed accordingly. This clarification shall apply only to these three Acts and not to any other enactment where the word "partnership" occurs.

(Source : http://mca.gov.in/Ministry/latestnews/Circular_04Apr2011.pdf)

Amendment in Council General Guidelines , 2008

The Chapter-XII Minimum Audit Fee in respect of Audit of the Council General Guidelines, 2008 appended to the ICAI publication titled " The Chartered Accountants Act, 1949" has been repealed with effect from 7th June, 2011

(Source : http://www.icai.org/new_post.html?post_id=7493&c_id=219)

Announcements - Definition of Relative in Chapter-IV of the Council General Guidelines, 2008

The Council of the Institute of Chartered Accountants of India, in terms of the decision taken at the 299th meeting held in October, 2010 has decided that the term "relative" for the purpose of Chapter-IV of Council General Guidelines, 2008 (Opinion on Financial Statements when there is substantial interest) will have the same meaning as assigned to it in AS-18.

Accordingly, the Chapter IV of the Council General Guidelines, 2008 as appended to the ICAI publication titled "The Chartered Accountants Act, 1949 " is modified and modified version shall read as under -

“Chapter IV: Opinion on financial statements when there is substantial interest

4.0 A member of the Institute shall not express his opinion on financial statements of any business or enterprise in which one or more persons who are his “relatives” within the meaning of Accounting Standard (AS - 18) has / have, either by themselves or in conjunction with such member, a substantial interest in the said business or enterprise.

Explanation: For this purpose and for the purpose of compliance of Clause (4) of Part I of the Second Schedule to the Chartered Accountants Act, 1949, the expression “substantial interest” shall have the same meaning as is assigned thereto under Appendix (9) to the Chartered Accountants Regulations, 1988. “

This decision shall be in force with effect from 28th June, 2011

(Source : http://www.icai.org/new_post.html?post_id=7494&c_id=219)

PART – II : QUESTIONS AND ANSWERS**QUESTIONS****Standards on Auditing, Statements and Guidance Notes**

1. Write short notes on the following:
 - (a) Financial indications to be considered for evaluating the assumption of going concern
 - (b) Auditor's responsibilities regarding comparatives.
 - (c) Sampling Risk
 - (d) Reporting on a compilation engagements
2. You are the principal auditor of Diamond Holdings Ltd. as a listed company, which has subsidiaries in the UAE and overseas, many of which are audited by other firms. All subsidiaries are involved in the manufacture or distribution of metal goods and have the same accounting period as Diamond Holdings Ltd. Outline why you would wish to review the work of the other auditors of subsidiaries not audited by your firm and detail the work you would carry out in that review.

Audit Strategy Planning and Programming

3.
 - (a) A & Co. was appointed as auditor of Great Airways Ltd. As the audit partner what factors shall be considered in the development of overall audit plan?
 - (b) You have been appointed as the auditor of a Multiplex Cinema House. Draw an audit programme in respect of its Revenue and Expenditure.

Risk Assessment and Internal Control

4. In the course of planning an audit several internal controls in the company's systems have been identified. List the conditions that each control must satisfy if it is to be relied upon in reducing the extent of substantive procedures to be performed.

Audit under CIS Environment

5. "The method of collecting audit evidence and evaluating the same changes drastically under CIS Environment". Comment on the above.

The Company Audit

6. As a Statutory Auditor, how would you deal with the following cases?
 - (a) During the course of audit of Arihant Ltd. it is noticed that out of ₹ 44 lakhs of provident fund contribution accounted in the books, only ₹ 4 lakhs has been remitted to the authorities during the year. On enquiry the Chief Accountant informed that due to financial problems they have not remitted but will remit the same as and when the position improves.
 - (b) M/s Lion's group gratuity scheme's valuation by actuary shows wide variation compared to the previous year's figures.
 - (c) In the books of accounts of M/s Opaque Ltd. huge differences are noticed between the control accounts and subsidiary records. The Chief Accountant informs that this is common due to huge volume of business done by the company during the year.

Liabilities of Auditors

7. 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?

Audit Report

8. The audit report of Perfact Ltd. for the year 2009-10 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2010-11, how would you report, if:
 - (a) The company does not make provision for doubtful debts in 2009-10?

- (b) The company makes adequate provision for doubtful debts in 2009-10?
9. As a Statutory Auditor, how would you report on the following under CARO:
- (a) O Pvt. Ltd. Is a dealer in Shares and Securities.
- (b) ABC Pvt. Ltd is a Manufacturer of jewellery. A senior employee of the Company informed you that the Company does not properly disclose the purity of gold used on the jewellery.

Audit of Banking Company

10. (a) While auditing the Branch of a Bank you are required to examine Inter Branch adjustments. Which points require your special attention?
- (b) How do you examine claims against the Bank not acknowledged as debts?

Audit of General Insurance Company

11. Enumerate the steps to be taken by an auditor for the verification of Re-insurance outward by a General Insurance Company.

Cost Audit

12. State the functions of Cost Auditor in respect of the following:
- (i) Inventory
- (ii) Labour
- (iii) Overhead and indirect expenditure.
- (iv) Work in Progress

Audit under Fiscal Laws

13. Discuss the reporting requirement in Form 3CD of Tax Audit Report under Section 44AB of the Income-tax Act, 1961 for the following:
- (a) Tax deducted at source.
- (b) Entrance fees paid to clubs.
14. TUI Ltd. an Indian company, subject to Indian Income tax Act, 1961, discloses advance Income-tax paid (Current tax asset) and provision for Income-tax (Current tax liability), separately in Balance Sheet for the year ended 31.3.2011, i.e., it does not offset the amount. Comment.

Audit of Public Sector Undertakings

15. (a) Briefly explain the Areas of propriety audit under Section 227(1A) of the Companies Act, 1956.
- (b) What are the principles involved regarding "Propriety audit" in the case of Public Sector Undertaking?

Special Audit

16. "In a depository system, securities are held in securities (depository) accounts; which are more or less similar to holding funds in bank accounts." In the light of the above briefly explain the provisions of depositories and its advantage?
17. Write a short note on the following
 - (a) Margins (Under Stock Exchange Trading Regulations).
 - (b) Types of market under NEAT (National Exchange Automated Trading)

Internal Audit, Management and Operational Audit

18. (a) K Ltd., requires you to organize a Management audit program. Briefly state a plan of action.
(b) You are appointed statutory auditor of X Ltd. X Ltd. has an internal audit system and reports for the same are given to you. Mention the factors you will consider to ensure that the said system of internal audit of X Ltd. is commensurate with the size of the company and nature of its business.

Investigation and Due Diligence

19. State the major Steps involved in the verification of assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank

Professional Ethics

20. Comment on the following with reference to the Chartered Accountants Act, 1949, Code of Ethics and Schedules to the Act:
 - (a) Ravi, a Chartered Accountant in practice provides management consultancy and other services to his clients. During 2011, looking to the growing needs of his clients to invest in the stock markets, he also advised them on Portfolio Management Services whereby he managed portfolios of some of his clients.
 - (b) Vijay, a Chartered Accountant in practice is a partner in 3 firms. While printing his personal letter heads, he gave the names of all the firms in which he is a partner.
 - (c) ABC & Associates, a firm with 5 partners developed a website *www.abcassociates.com*. The website also contained a link to "All India Chartered Accountants Association", a voluntary association where X, a partner of the firm is currently the Vice-president.
 - (d) M/s XYZ, a firm of Chartered Accountants responded to a tender from a State Government for computerization of land revenue records. For this purpose, the firm also paid ₹ 1,50,000 as earnest deposit as part of the terms of the tender.

SUGGESTED ANSWERS/HINTS

1. (a) **Financial Indications and Going Concern:** SA 570 on "Going Concern", aims to establish standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the preparation of the financial statements. The following are the financial indications to be considered:

- " Net liability or net current liability position.
- " Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- " Indications of withdrawal of financial support by creditors.
- " Negative operating cash flows indicated by historical or prospective financial statements.
- " Adverse key financial ratios.
- " Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- " Arrears or discontinuance of dividends.
- " Inability to pay creditors on due dates.
- " Inability to comply with the terms of loan agreements.
- " Change from credit to cash-on-delivery transactions with suppliers.
- " Inability to obtain financing for essential new product development or other essential investments.

- (b) **Auditor's responsibilities regarding comparatives:** SA 710, "Comparative Information – Corresponding Figures and Comparative Financial Statements", establishes standards on the auditor's responsibilities regarding comparatives.

The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

- (i) The comparative information agrees with the amounts and other disclosures presented in the prior period; and
- (ii) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for

and adequately presented and disclosed.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of SA 560 (Revised).

As required by SA 580 (Revised), the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year's statement of profit and loss.

- (c) **Sampling Risk:** As per SA 530 "Audit Sampling", the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:
- (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
 - (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.
- (d) **Reporting on a compilation engagements:** SA 4410 "Engagements to Compile Financial Information", the report on compilation engagements should, ordinarily, be in the following lay out:
- (i) *Title:* The title of the report should be "Accountant's Report on Compilation of Unaudited Financial Statements" (and not "Auditor's Report");
 - (ii) *Addressee:* The report should ordinarily be addressed to the appointing authority;
 - (iii) Identification of the financial information also noting that it is based on the information provided by the management;
 - (iv) When relevant, a statement that the accountant is not independent of the entity;

- (v) A statement that the management is responsible for:
 - “ completeness and accuracy of the underlying data and complete disclosure of all material and relevant information to the accountant;
 - “ maintaining adequate accounting and other records and internal controls and selecting and applying appropriate accounting policies;
 - “ preparation and presentation of financial statements or other financial information in accordance with the applicable laws and regulations, if any;
 - “ establishing controls to safeguard the assets of the entity and preventing and detecting frauds or other irregularities;
 - “ establishing controls for ensuring that the activities of the entity are carried out in accordance with the applicable laws and regulations and preventing and detecting any non-compliance;
- (vi) A statement that the engagement was performed in accordance with this Standard on Related Services;
- (vii) A statement that neither an audit nor a review has been carried out and that accordingly no assurance is expressed on the financial information;
- (viii) A paragraph, when considered necessary, drawing attention to the disclosure of material departures from the identified financial reporting framework;
- (ix) Date of the report;
- (x) Place of signature; and
- (xi) Accountant's signature

The financial statements or other financial information compiled by the accountant should contain a reference such as “Unaudited,” “Compiled without Audit or Review” and also “Refer to Compilation Report” on each page of the financial information or on the front of the complete set of financial statements.

2. **Reason for reviewing the work of the auditors:** The main consideration which concerns the audit of all group accounts is that the parent company's, auditors (the 'principal' auditors) are responsible to the members of that company for the audit opinion on the whole of the group accounts.

It may be stated (in the notes to the financial statements) that the financial statements of certain subsidiaries have been audited by other firms, but this does not absolve the principal auditors from any of their responsibilities. The auditors of a parent company have to report to its members on the truth and fairness of the view given by the financial statements of the company and its subsidiaries dealt with in the group accounts. The principal auditors should have powers to obtain such information and explanations as they reasonably require from the subsidiary companies and their auditors, or from the

parent company in the case of overseas subsidiaries, in order that they can discharge their responsibilities as parent company auditors.

SA 600 Using the work of another auditor clarifies how the principal auditors can carry out a review of the audits of subsidiaries in order to satisfy themselves that, with the inclusion figures not audited by them, the group accounts give a true and fair view.

Further, while planning to use the work of another auditor, the principal auditor should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.

The scope, standard and independence of the work carried out by the auditors of subsidiary companies (the 'other' auditors) are the most important matters which need to be examined by the principal auditors before relying on financial statements not audited by them. The principal auditors need to be satisfied that all material areas of the financial statements of subsidiaries have been audited satisfactorily and in a manner compatible with that of the principal auditors themselves.

Work to be carried out by principal auditors in reviewing the other auditor's work

- (i) Send a questionnaire to all other auditors requesting detailed information on their work, including
 - Ø An explanation of their general approach (in order to make an assessment of the standards of their work)
 - Ø Details of the accounting policies of major subsidiaries (to ensure that these are compatible within the group)
 - Ø The other auditor's opinion of the subsidiaries' overall level of internal control, and the reliability of their accounting records.
 - Ø Any limitations placed on the scope of the auditors' work
 - Ø any qualifications, and the reasons for them, made or likely to be made to their audit reports
- (ii) Carry out a detailed review of the other auditors' working papers on each subsidiary whose results materially affect the view given by the group financial statements. This review will enable the principal auditors to ascertain whether (*inter alia*):
 - Ø An up-to-date permanent file exists with details of the nature of the subsidiary's business, its staff organization, its accounting records, previous year's financial statements and copies of important legal documents.
 - Ø The systems examination has been properly completed, documented and reported on to management after discussion.
 - Ø Tests of controls and substantive procedures have been properly and appropriately carried out, and audit programmes properly completed and signed

- Ø All other working papers are comprehensive and explicit.
- Ø The overall review of the financial statements has been adequately carried out, and adequate use of analytical procedures has been undertaken throughout the audit.
- Ø The financial statements agree in all respects with the accountings records and comply with all relevant legal requirements and accounting standards.
- Ø Minutes of board and general meetings have been scrutinized and important matters noted.
- Ø The audit work has been carried out in accordance with approved auditing standards
- Ø The financial statements agree in all respects with the accounting records and comply with all relevant legal and professional requirements.
- Ø The audit work has been properly reviewed within the firm of auditors and any laid-down quality control procedures adhered to.
- Ø Any points requiring discussion with the parent company's management have been noted and brought to the principal auditors' attention (including any matters which might warrant a qualification in the audit report on the subsidiary company's financial statements).
- Ø Adequate audit evidence has been obtained to form a basis for the audit opinion on both the subsidiaries financial statements and those of the group.

If the principal auditors are not satisfied as a result of the above review, they should arrange for further audit work to be carried out either by the other auditors on their behalf, or jointly with them. The other auditors are fully responsible for their own work and additional tests are those required for the purpose of the audit of the group financial statements.

3. (a) **Development of an overall plan** - Overall plan is basically intended to provide direction for audit work programming and includes the determination of timing, manpower development and co-ordination of work with the client, other auditors and other experts. The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit.
- (i) Terms of his engagement and any statutory responsibilities.
 - (ii) Nature and timing of reports or other communications.
 - (iii) Applicable Legal or Statutory requirements.
 - (iv) Accounting policies adopted by the clients and changes, if any, in those policies.
 - (v) The effects of new accounting and auditing pronouncement on the audit.

- (vi) Identification of significant audit areas.
- (vii) Setting of materiality levels for the audit purpose.
- (viii) Conditions requiring special attention such as the possibility of material error or fraud or involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- (ix) Degree of reliance to be placed on the accounting system and internal control.
- (x) Possible rotation of emphasis on specific audit areas.
- (xi) Nature and extent of audit evidence to be obtained.
- (xii) Work of the internal auditors and the extent of reliance on their work, if any in the audit.
- (xiii) Involvement of other auditors in the audit of subsidiaries or branches of the client and involvement of experts.
- (xiv) Allocation of works to be undertaken between joint auditors and the procedures for its control and review.
- (xv) Establishing and coordinating staffing requirements.

(b) Audit Programme of Multiplex

- (i) Peruse the Memorandum of Association and Articles of Association of the entity.
- (ii) Ensure the object clause permits the entity to engage in this type of business.
- (iii) In the case of income from sale of tickets:
 - (1) Verify the control system as to how it is ensured that the collections on sale of tickets of various shows are properly accounted.
 - (2) Verify the system of relating to on line booking of various shows and the system of realization of money.
 - (3) Check that there is overall system of reconciliation of collections with the number of seats available for different shows on a day.
- (iv) Verify the internal control system and its effectiveness relating to the income from cafes shops, pubs etc., located within the multiplex.
- (v) Verify the system of control exercised relating to the income receivable from advertisements exhibited within the premises and inside the hall such as hoarding, banners, slides, short films etc.
- (vi) Verify the system of collection from the parking areas in respect of the vehicles parked by the customers.

- (vii) In the case of payment to the distributors verify the system of payment which may be either through out right payment or percentage of collection or a combination of both. Ensure at the time of settlement any payment of advance made to the distributor is also adjusted against the amount due.
 - (viii) Verify the system of payment of salaries and other benefits to the employees and ensure that statutory requirements are complied with.
 - (ix) Verify the payments effected in respect of the maintenance of the building and ensure the same is in order.
4. **The conditions that each control must satisfy if it is to be relied upon in reducing the extent of substantive procedures to be performed are as follows:**
- (i) Whether the controls have operated throughout the year
 - (ii) Whether the control has been evidenced and tested
 - (iii) Whether reliance on the control assists audit objectives, that is, whether it is relevance to the validity of a financial statement ascertain, such as that sales are complete
 - (iv) Whether it is cost effective to test controls
 - (v) Whether the results of tests of controls are satisfactory.
5. Auditor must provide a competent, independent opinion as to whether the financial statements records and report a true and fair view of the state of affairs of an entity. However, computer systems have affected how auditors need to collect and evaluate evidence. These aspects are discussed below:
- (i) **Changes to Evidence Collection** - Collecting evidence on the reliability of a computer system is often more complex than collecting evidence on the reliability of a manual system. Auditors have to face a diverse and complex range of internal control technology that did not exist in manual system, like:
- (1) accurate and complete operations of a disk drive may require a set of hardware controls not required in manual system,
 - (2) system development control include procedures for testing programs that again are not necessary in manual control.
- Since, Hardware and Software develop quite rapidly, understanding the control technology is not easy. With increasing use of data communication for data transfer, research is focused on cryptographic controls to project the privacy of data. Unless auditor's keep up with these developments, it will become difficult to evaluate the reliability of communication network competently.
- The continuing and rapid development of control technology also makes it more difficult for auditors to collect evidence on the reliability of controls. Even collection

of audit evidence through manual means is not possible. Hence, auditors have to run through computer system themselves if they are to collect the necessary evidence. Though generalized audit softwares are available the development of these tools cannot be relied upon due to lack of information. Often auditors are forced to compromise in some way when performing the evidence collection

- (ii) **Changes to Evidence Evaluation** - With increasing complexity of computer systems and control technology, it is becoming more and more difficult for the auditors to evaluate the consequences of strength and weaknesses of control mechanism for placing overall reliability on the system.

Auditors need to understand:

- (1) whether a control is functioning reliably or multi functioning,
- (2) traceability of control strength and weakness through the system. In a shared data environment a single input transaction may update multiple data item used by diverse, physically disparate user, which may be difficult to understand.

Consequences of errors in a computer system are a serious matter as errors in computer system tend to be deterministic, i.e., an erroneous program will always execute data incorrectly. Moreover, the errors are generated at high speed and the cost and effort to correct and rerun program may be high. Errors in computer program can involve extensive redesign and reprogramming. Thus, internal controls that ensure high quality computer systems should be designed implemented and operated upon. The auditors must ensure that these control are sufficient to maintain assets safeguarding, data integrity, system effectiveness and system efficiency and that they are in position and functioning.

6. (a) **Depositing Provident Fund Dues:** The Companies Audit Report's Order, 2003 required the auditor to state whether the undisputed dues of provident fund have been regularly deposited with the appropriate authorities and, if not, *the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.*

In this case there is a default in not depositing the provident fund contribution to the extent of ₹ 40 lakhs which is a lapse on the part of the company. The reason put forward by the Chief Accountant that the amount has not been deposited due to financial problems faced by the Company is no excuse for not remitting the provident fund. In fact, the company has not at all been regular in depositing the amount. Thus, the auditor shall include this in his report indicating the extent of arrears.

- (b) **Valuation by Actuary:** SA 620, "Using the Work of an Expert" states that the auditor has to evaluate the work of an expert, say, actuary, before adopting the

same. This becomes more crucial since M/s Lion's group gratuity scheme's valuation by actuary shows wide variation compared to previous year figures. There is no doubt that appropriateness, reasonableness of assumptions and methods used are the responsibility of the expert, but the auditor has to determine whether they are reasonable based on the auditor's knowledge of the client's business and result of his audit procedures. In the present case, the auditor must verify the reasonableness of assumptions made and methods adopted by the actuary in the evaluation particularly with reference to factors such as rate of return on investments, retirement age, number and salary of employees, etc. Accordingly, the auditor has to satisfy himself whether valuation done by the actuary can be adopted, otherwise he may report on his findings for wide variation.

(c) **Difference between Control Accounts and Subsidiary Records:** The huge differences found between control accounts and subsidiary records in the books of M/s Opaque Ltd. indicate that there may be material misstatements requiring detailed examination by the auditor to ascertain the cause. The contention of Chief Accountant cannot be accepted simply because the company has done huge volume of business. Such a phenomenon indicates that recording of transactions is not being done properly or the accounting system in the company which might have several branches spread over the country fails to capture all transactions in time. It would also be interesting to see whether it is a recurring phenomenon or such reconciliation could not be done at a subsequent date. Having regard to all these circumstances, it appears from the facts of the case that these differences indicate the possibility of some kind of material misstatements. Further, when the auditor encounters circumstances that there is material misstatement, the auditor should perform procedures to determine whether the financial statements are materially misstated. If as a result of such examination the auditor comes across any material information involving fraud or gross irregularity the same shall be reported by him appropriately.

7. Schedule VI to the Companies Act, 1956 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 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.

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. **Reporting under CARO, 2003**

- (a) O Pvt. Ltd. is a dealer in shares and securities. Clause (xiv) of CARO, 2003 is applicable to a company in case it is dealing or trading in shares, securities, debentures and other investments. The requirements applicable to O Pvt. Ltd. would be as under:

- “ whether proper records are maintained for transactions and contracts;
- “ whether timely entries are made in such records; and
- “ whether shares, securities, debentures and other investments have been held by the company in its own name except to the extent of exemption, if any granted under section 49 of the Companies Act, 1956.

In case auditor is satisfied in respect of aforesaid matters, after making examination, the auditor may report as under:

“In our opinion, and according to information and explanation given to us, the company has been maintained proper records in respect of transactions and

contracts in securities during the year and timely entries have been made therein. Further, all shares and certificates are held by the company in its own name."

- (b) In the case of ABC Pvt. Ltd. If purity of gold is not properly disclosed on the jewellery it amounts to defrauding the customers. That means the management is deceiving customers to obtain an illegal advantage. However, the auditor is concerned with fraudulent acts that cause a material misstatement in financial statements. As long as books of account are not falsified arising out of difference in the purity of gold, i.e., actual cost of the gold and the sale price of gold, it has no implication for the auditor. Further, under CARO, 2003, the auditor may examine this from the view point of maintaining proper records of inventory. But even the requirement of maintaining proper records does not necessitate that purity as such should be mentioned on the gold itself. However, the purity of gold would have implication on the valuation of inventory. But this aspect is not required to be reported under CARO, 2003.

Thus, from the view point of reporting on frauds under CARO, 2003, there is no implication for misstatement in the financial statements. Hence, no reporting is necessary for non-proper disclosure of purity of gold on the jewelry.

10. (a) **Special points to examine Inter Branch adjustments:** The following points require special attention in the examination of Inter Branch transactions.
- (i) While verifying the closing balance, special attention should be paid to the origin and validity of old outstanding unmatched entries, particularly debit entries. The auditor may also seek confirmation of transactions relating to outstanding in appropriate cases.
 - (ii) Whether there are any reversal entries indicating the possibility of irregular payments or frauds.
 - (iii) Whether the balances include any items in the nature of cash in transit included in this head which remain pending for more than a reasonable period. This is because such items are not expected to remain outstanding beyond a very small period during which they are in transit.
 - (iv) Whether transactions other than those relating to inter branch transactions have been included in inter branch accounts. Any unusual items put through inter branch accounts as well as old or large entries outstanding in Inter branch accounts should be carefully looked into. The auditor should also seek explanations from the Management in this regard in appropriate cases.
- (b) **Examination of claims against the Bank not acknowledged as debts:** The auditor should examine the relevant evidence, for example correspondence with lawyers, claimants, workers/officers and workmen's/officer's unions. The auditor should also review the minutes of the meeting of the Board of directors/committees of the Board, contracts, agreements and arrangements, list of pending legal cases

and correspondence relating to taxes, duties etc., to identify claims against the bank. The auditor should ascertain from the management the status of claims outstanding as at the end of previous year. A review of subsequent events would also provide evidence about completeness and valuation of claims.

11. Verification of Re-insurance outward : The following steps may be taken by the auditor in the verification of re-insurance outward;

- (i) The auditor should verify that re-insurance underwriting returns received from the operating units regarding premium, claims paid, outstanding claims tally with the audited figures of premium, claims paid and outstanding claims.
- (ii) The auditor should check whether the pattern of re-insurance underwriting for outward cessions fits within the parameters and guidelines applicable to the relevant year.
- (iii) The auditor should also check whether the cessions have been made as per the stipulation applicable to various categories of risk.
- (iv) The auditor should verify whether the cessions have been made as per the agreements entered into with various companies.
- (v) It should also be seen whether the outward remittances to foreign re-insurers have been done as per the foreign exchange regulations.
- (vi) It should also be seen whether the commission on cession has been calculated as per the terms of the agreement with the re-insurers.
- (vii) The auditor should verify the computation of profit commission for various automatic treaty arrangements in the light of the periodical accounts rendered and in relation to outstanding loss pertaining to the treaty.
- (viii) The auditor should examine whether the cash loss recoveries have been claimed and accounted on a regular basis.
- (ix) The auditor should also verify whether the Claims Paid item appears in Outstanding Claims list by error. This can be verified at least in respect of major claims.
- (x) He should see whether provisioning for outstanding losses recoverable on cessions have been confirmed by the re-insurers and in the case of major claims, documentary support should be insisted and verified.
- (xi) Accounting aspects of the re-insurance cession premium, commission receivable, paid claims recovered, and outstanding losses recoverable on cessions have to be checked.
- (xii) The auditor should check percentage pattern of gross to net premium, claims paid and outstanding claims to ensure comparative justification.
- (xiii) The auditor should also check that the re-insurers balance on cessions and whether the sub ledger balances tallies with the general ledger balances.

- (xiv) The auditor should review the individual accounts to find out whether any balance requires provisioning / write off or write back.
 - (xv) He should verify whether the balances with re-insurers are supported by necessary confirmation obtained from them.
 - (xvi) He should verify whether opening outstanding claims not paid during the year find place in the closing outstanding claims vis-a-vis the reinsurance inwards outstanding losses recoverable on cessions appears in both opening and closing list. If not, the reason for the same should be analysed.
 - (xvii) Any major event after the Balance Sheet date which might have wider impact with reference to subsequent changes regarding the claim recovery both paid and outstanding and also re-insurance balances will need to be brought out suitably.
12. **Functions of Cost Auditor:** The Institute of Cost and Works Accountants of India has detailed the principal functions of a cost auditor by way of comparison with the functions of the auditor of financial accounts. The principal functions of cost auditor, according to the aforesaid Institute are the following:
- (i) **Inventory**
 - (a) Is the size of the inventory adequate or excess compared with the production programme?
 - (b) Is the provision most economical?
 - (c) Does it ensure optimum order size?
 - (d) Does it take into account the storage cost on the one hand, and carrying cost on the other?
 - (e) Does it take note of lead time of the various items or groups of items?
 - (f) Does the receipt and issue system cause any bottle-neck in production?
 - (g) Does it involve too many forms and too much paper work?
 - (h) Is there any room for reduction of inventory cost consistent with production needs?
 - (i) Is the inventory as per the priced store ledger and as certified by the management physically correct?
 - (j) Is the same amount of attention and care given to monies translated into material things like raw materials, stores and supplies of all kinds as given to liquid cash?
 - (k) Does the issue of raw materials make the production in accordance with the standard or schedule or otherwise or covered by authorised schedule?
 - (i) Is the expenditure of consumable stores within the standard? If not, why not?

(ii) Labour -

- (a) Proper utilisation of labour and increase in productivity are now receiving attention, several productivity teams have emphasised importance of higher productivity. It is, therefore, essential to assess the performance efficiency of labour and compare it with standard performance, so that labour utilisation could be progressively improved. The labour force in Indian industries is generally very high compared to similar types of industries in other developed countries. Our aim should be to reach that level, though not immediately but over some time. A study of this nature would give an idea where the inefficiency lies so that timely and adequate steps could be taken to ensure maximum utilisation of labour to reduce labour cost.
- (b) Cost of labour is allocated to different jobs with reference to time or job cards.

(iii) Overheads and indirect expenditure - The cost auditor will see and certify:

- (a) that allocation of indirect expenditure over production, sales, and distribution is logical and correct;
- (b) that compared with the value of production in a production shop, overhead charges are not excessive;
- (c) that actual indirect expenditure does not exceed budgets or standard expenditure significantly and that any variations are satisfactorily explained and accounted for;
- (d) that the relation of indirect expenditure in keeping with the load on individual production shop is appropriate;
- (e) correctness of appropriate allocation of overhead expenditure (both production and sales) will be certified by the cost auditor;
- (f) that allocation of overheads between finished products and unfinished products is in accordance with correct principles.

(iv) Work-in Progress - The Cost Auditor will see the following:

- (a) that work-in-progress has been physically verified and that it agrees with the balance in the incomplete cost card;
- (b) that valuation of the work-in-progress is correct with reference to stage of completion of each job or process and the value job cost cards or process cost sheet;
- (c) that there is no over-valuation or under-valuation of opening work-in-progress or closing work-in-progress, thereby artificially pushing up and down net profits or net assets as the case may be;
- (d) that the volume and value of work-in-progress is not disproportionate compared with the finished out-turn.

13. (a) Under clause 27, following particulars as to tax deduction has to be furnished in Form 3CD as under:

(1) Whether the assessee has complied with the provisions of Chapter XVII-B regarding deduction of tax at source and regarding the payment thereof to the credit of the Central Government [Yes/No]

(2) If the provisions of Chapter XVII-B have not been complied with please give the following details*, namely:

		Amount
(i)	Tax deductible and not deducted at all
(ii)	Shortfall on account of lesser deduction than required to be deducted
(iii)	Tax deducted late
(iv)	tax deducted but not paid to the credit of the Central Government

In case test checking has been done for the above (in case of voluminous data) an appropriate disclosure for the same is to be given.

- (b) Reporting for expenditure incurred at clubs is to be given as per clause 17(d) of Form 3CD. The payments may be for entrance fees as well as membership subscription and for catering and other services by the club, both in respect of directors and other employees in case of companies and for partners or proprietors in other cases. The fact whether such expenses are incurred in the course of business or whether they are of personal nature should be ascertained. If they are personal in nature, they are to be shown separately under Clause 17(b). Hence, the tax auditor has to report the payments to clubs under Clause 17 (d) of Form 3CD.
14. As per paragraph 27 of Accounting Standard(AS) 22 – Accounting for Taxes on Income, an enterprise should offset assets and liabilities representing current tax if the enterprise:
- (i) has a legally enforceable right to set off the recognized amounts and
 - (ii) intends to settle the asset and liability on a net basis.

An enterprise will normally have a legally enforceable right to set off an asset and liability representing current tax when they relate to income taxes levied under the same governing taxation laws and the taxation laws permit the enterprise to make or receive a single net payment.

Since TUI Ltd is an Indian Company, and as per Income Tax Act, 1961, such set off is allowed which is legally enforceable. Thus, in view of Provisions of AS 22 and Income Tax Laws, TUI Ltd. should off set advance tax paid against provision for income tax and show only the net amount in the balance sheet.

15. (a) **Areas of propriety audit under Section 227(1A)** : Section 227(1A) of the Companies Act, 1956 requires the auditor to make an enquiry into certain specific areas. In some of the areas, the auditor has to examine the same from propriety angle as to:
- (i) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members;
 - (ii) Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company;
 - (iii) Whether the company is not an investment company within the meaning of section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
 - (iv) Whether loans and advances made by the company have been shown as deposits. Again, considering the propriety element, rationalizing the proper disclosure of loans and advance given by company is made;
 - (v) Whether personal expenses have been charged to revenue account;
 - (vi) In case it is stated in the books and papers of the company that shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash actually received, whether the position in books of account and balance sheet so stated is correct, regular and not misleading. A control has been set up to verify the receipt of cash in case of allotment of shares for cash. Further, if cash is not received, the books of accounts and statement of affairs shows the true picture
- (b) Section 619 of the Companies Act, 1956 lays down special provisions regarding audit of accounts of public sector undertakings registered as Government Companies. Section 619(4) of the Companies Act, 1956 empowers C&AG to conduct supplementary or test audit. Audit of public enterprises in India is not restricted to financial and compliance audit; it extends also to efficiency, economy and effectiveness with which these operate and fulfil their objectives and goals. Another aspect of audit relates to questions of propriety; this audit is directed towards an examination of management decisions in sales, purchases, contracts, etc. to see whether these have been taken in the best interests of the undertaking and conform to accepted principles of financial propriety. Propriety audit stands for verification of transactions on the tests of public interest, commonly accepted customs and standards of conduct. On an analysis, these tests boil down to tests of economy, efficiency and faithfulness. Instead of too much dependence on documents, vouchers and evidence, it shifts the emphasis to the substance of transactions and looks into the appropriateness thereof on a consideration of

financial prudence, public interest and prevention of wasteful expenditure. Thus, propriety audit is concerned with scrutiny of executive actions and decisions bearing on financial and profit and loss situation of the company, with special regard to public interest and commonly accepted customs and standards of conduct. It is also seen whether every officer has exercised the same vigilance in respect of expenditure incurred from public money, as a person of ordinary prudence would exercise in respect of expenditure of his own money under similar circumstances. Some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

- (i) The expenditure should not be *prima facie* more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.
- (ii) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.
- (iii) Public moneys should not be utilised for the benefit of a particular person or section of the community.
- (iv) Apart from the agreed remuneration or reward, no other avenue is kept open to indirectly benefit the management personnel, employees and others.

It may be stated that it is the responsibility of the executive departments to enforce economy in public expenditure. The aim of propriety audit is to bring to the notice of the proper authorities of wastefulness in public administration and cases of improper; avoidable and in fructuous expenditure.

16. *Depositories*– The entire transaction of purchase or sale of securities can be said to be completed only after the buyer becomes the rightful owner of the securities and the seller gets the sale consideration. Traditional settlement system on the Indian stock markets gave rise to settlement risk due to the time that lapsed before trades were settled. Further, transfer of securities involved sending the same along with sellers' endorsement on transfer deed for registration to the issuer. In many cases, the process took much longer than two months and significant proportion of transactions ended up as bad delivery due to faulty compliance of paper work. Theft, forgery, mutilation of certificates and other irregularities were rampant and in addition to the issuers right to refuse the transfer of security. To obviate these problems, the Depositories Act, 1996 was enacted to provide for establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by:

- (a) making securities of public limited companies freely transferable subject to certain exceptions;

- (b) dematerialising the securities in the depository mode; and
- (c) providing for maintenance of ownership records in book entry form.

In order to streamline both the stages of settlement process, the Depositories Act, 1996 envisaged transfer of ownership of securities electronically by book entry without making the securities moving from person to person. The Act made the securities of public limited companies freely transferable by restricting the company's right to use discretion in effecting the transfer of securities, thus, dispensing with the transfer deed and other procedural requirements under the Companies Act, 1956.

In a depository system, securities are held in securities (depository) accounts; which are more or less similar to holding funds in bank accounts. Transfer of ownership of securities is done through simple account transfers.

Advantages of Depository Services -

- (i) High liquidity of scrips due to immediate transfer and registration.
 - (ii) Receive bonus and right as direct credit to the account thereby eliminating the risk of loss in transit.
 - (iii) Much lower risk of bad deliveries.
 - (iv) Reduction in brokerage.
 - (v) Saving of stamp duty worth 1% of transaction price.
 - (vi) Saving of courier, notary charges.
 - (vii) Saving of expenses to be incurred on obtaining duplicate certificates as no threat of original shares getting mutilated or misplaced.
17. (a) **Margins:** Margin refers to deposit made by members with the stock exchange authorities. There can be wide fluctuations at the time of settlement in the prices of securities since the closing rate of the earlier settlement. In order to restrict excessive speculation and also to safeguard the interests of the investors, members are required to keep certain deposits with the stock exchange authorities. These deposits are termed 'margins'. The members are required to collect the margin from their clients, wherever applicable, and deposit the amount collected with the Clearing House. Margin is intended to protect the members by providing them with funds to cover anticipated fluctuations in prices of securities, particularly, if the client delays in paying the amount or is unable to meet his commitments. Margins also help prevent excessive speculation as clients would be required to invest some funds and not indulge in speculation without adequate resources. A member is required to pay or deposit different margins such as Gross Exposure Margin, Mark to Market (MTM) Margin, Volatility Margin (VM), Additional Volatility Margin (AVM), Special Margin and Adhoc Margin. The members are required to compute margin payable for all securities traded by them and make the margin payments on the due

date to the Stock Exchange authorities. Different types of margins are payable at stipulated time, as decided by the Exchange or Clearing House of the Exchange.

- (b) **Type of markets under NEAT:** The NEAT system has four main types of market. They are:

Normal Market: All orders which are of regular lot size or multiples thereof are traded in the normal market. For shares which are traded in the compulsory dematerialised mode the market lot of these shares is one. Normal market consists of various book types wherein orders are segregated as regular lot orders, special term orders, negotiated trade orders and stop loss orders, depending on their order attributes.

Odd Lot Market: An order is called an odd lot order if the order size is less than regular lot size; such orders are traded in the odd-lot market. These orders do not have any special terms or attributes attached to them. In an odd-lot market, both the price and quantity of both the orders (buy and sell) should exactly match for the trade to take place.

Spot Market: Spot orders are similar to the normal market orders except that spot orders have different settlement periods vis-à-vis normal market. These orders do not have any special terms or attributes attached to them.

Auction Market: In the auction market, auctions are initiated by the Exchange on behalf of trading members for completing the settlement process.

18. (a) **Organizing a Management Audit for K Ltd.:** The key requirement for a successful Management audit program would be the approval and support of the top management to initiate. Accordingly the following shall be the matters that should be considered while organizing the Management Audit of K. Ltd.

Devising the statement of policy - The management's support must be reflected clearly and categorically in the company's highest policy statement. The policy statement should be quite specific. It should spell out clearly the scope and status of the management/operational auditing within the enterprise, its authority to carry out audits, issue reports, make recommendations, and evaluate corrective action. The statement of policy should lay down in clear terms the scope of activities to be performed by the management auditor. The scope of activities is the most basic requirement for building up a successful management audit programme both for small as well as a large organisation. Thus, a comprehensive statement of policy provides definite understanding to management concerning the nature of audit to be performed and the scope and details of audit work to be carried out. This then will become the charter under which the management auditor should operate. In this charter, will be set forth, for the rest of the company to see, how executive management regards the purpose, mission and authority of the function of management auditor within the company. The statement must afford the auditor all

the authority he needs yet does not assign responsibility which he cannot conceivably carry out. The statement must categorically say that the management auditor is capable of reviewing administrative and management controls over any activity within the company. However, he should not be expected to extend his activities to the evaluation of performance of professional and technical activities calling for specialised knowledge and skills and suggest remedies unaided by people competent to undertake such evaluation.

Location of audit function within the organisation - Some organisations depending upon their size and nature of have established a separate department of audit specialists where the head of the department reports directly to the top executive. In certain cases, the audit group may be a part of the activities of management services department, administrative control department or some other unit of organisation. The more important question, however, is that the function should be as entirely independent as possible of pressure from various groups in the enterprise. The greater the independence, greater is the freedom to work effectively. Therefore, it is better to place the auditing function quite high in the organisation. The minimum requirement for the auditing organisation is to report to an officer whose status is such that he can command prompt and proper consideration of the auditor's opinion and recommendations. Preferably that officer should be a member of the Board. One of the controversies that is usually raised is whether the management auditor should report to the finance director, to whom he may be administratively responsible or to the managing director where he has no administrative responsibility. A third opinion would like the auditor to report to an audit committee, comprising of senior executives of the company who are preferably Board members. A different school of thought would like auditors to report to both the finance director and the audit committee. Though the controversy rages and no definite solution can be arrived at, it is felt that the controversy regarding which of these persons the management auditor should report to is not much substance where independence exists. Independence of the management auditor is not necessarily related to the person/persons he reports. His independence is entirely dependent on the management's attitude towards audit, the credibility the management auditor has with the management and the management's positive will to listen to criticism for self betterment.

Allocation of personnel - Whatever be the size of the enterprise, it is important that all persons selected and assigned to audit possess a good understanding of auditing theory, a thorough knowledge of the fundamentals of both organisation and management, the principles and effective methods of control, and the requirements for conducting scientific appraisal. "General Guidelines on Internal Auditing" issued by the Institute also emphasize these qualifications for an auditor whose area extends beyond the review of financial controls. As the management auditor is expected to evaluate operational performance and non-monetary operational

controls, he should possess basic knowledge of the technology and commercial practices of the enterprise, an enquiring, analytical, pragmatic and imaginative approach and a thorough understanding of the control system. The management auditor should also have a basic knowledge of commerce, law, taxation, cost accounting, economics, quantitative methods and EDP systems. Knowledge in these areas would be adequate for him to identify problems and to determine steps to be taken when a problem is identified. It does not mean that management audit should be assigned to engineers, computer experts and others. Rather persons having sound accounting background alongwith general knowledge of other relevant disciplines are best suited to perform this job. Because the profession of accountancy basically teaches a systematic and analytical approach to a problem, it is this methodical approach which is the guiding note to an audit function of review of controls. In personal characteristics individuals assigned to the job should have an inclination towards analysis, a high degree of imagination and an ability to write and express themselves clearly and logically.

Staff training programme - A continuous training programme is necessary to achieve quality in performing audit assignments because the management auditor must keep a breast of new ways to improve auditing standards. An effective training programme enables staff to assume additional responsibilities and advancements in the organisation. Thus the programme acts as an incentive for drawing capable people into the department and keeping them.

Time and other aspects - The time required to carry out a management audit will vary, depending upon the extent and nature of assignment. For example, the time required to perform an audit of the entire activities of an organisation's purchasing department might take a few weeks, while an audit of the entire business could take several months. Much depends upon the size of the activity. An appraisal of a plant's standard cost system might also simultaneously include an appraisal of the departmental budgetary control system. In a study of the results of sales contacts and selling efforts in the field, one might find it feasible to study the expense reports and other costs incurred in making contacts. In the evaluation of the method of scheduling production in a plant, one might well take a good look at the sales department's method of compiling and preparing the sales forecast. The time and cost will vary for each assignment, depending upon the nature of the assignment, the number of auditors assigned to perform the work, and whether or not more specialists in a particular field are required. An audit of a production planning and control department, for example because of its size and other factors, could require an audit staff of several persons and, in addition, a specialist in production planning and one in production control. If an assignment is one which requires technical assistance of a nature unavailable within the audit group, it might be advisable to seek a qualified outside consultant to perform the work.

Frequency - Having specified various approaches to management audit, including its scope and its staffing requirements the last item that should be considered before undertaking such an audit is its frequency. Prime consideration should be given to the nature of the organisation. Is the company in a fast-changing industry where there is great accent on the latest technology in the company's products and/or services? When the organisation is subject to rapid change or the total resources utilised are expensive, the frequency of management auditing should be greater than when it does not undergo rapid changes or the resources employed are not high in value. In essence, management audits should be made often enough to provide protection against growing problems. On the other hand, they should not be so frequent as to lead to repetitious results of questionable value.

To get an idea of the optimum frequency of such an audit, it might be worthwhile to look at financial audits. Customarily, financial audits are conducted annually. They are highly programmed, since an internal control questionnaire is utilised to attest to accounting methods and procedures. By contrast, a management audit should be considered from a longer time frame. For an organisation, that is subject to rapid changes or consumes a great amount of high-cost resources, a two-years basis might be adequate to protect it from managerial and operational problems becoming entrenched or too large. For those organisations in a relatively stable industry, the frequency of audit can be every three years. In no case should the interval be allowed to exceed three years.

- (b) As per SA 610 (Revised) "Using the Work of Internal Auditor" the statutory auditor has to consider the following before placing reliance on the same".
- (i) Organizational status – whether the same is done internally or by an external agency.
 - (ii) Scope of work – What is the nature and depth of the coverage of the assignment.
 - (iii) Technical competence – Whether the internal auditor is technically competent to do the work i.e. having adequate technical training and proficiency.
 - (iv) Due professional care – Whether his work and reports appear to be properly planned, supervised reviewed and documented.
 - (v) Audit Evidence - Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;
 - (vi) Conclusions - Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and
 - (vii) Response to unusual matters - Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

If the above factors are not satisfactory, the statutory auditor will have to modify his audit program and increase the verification to be carried out.

19. Steps involved in the verification of assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank - The investigating accountant should prepare schedules of assets and liabilities of the borrower and include in the particulars stated below:

(a) **Fixed assets** - A full description of each item, its gross value, the rate at which depreciation has been charged and the total depreciation written off. In case the rate at which depreciation has been adjusted is inadequate, the fact should be stated. In case any asset is encumbered, the amount of the charge and its nature should be disclosed. In case an asset has been revalued recently, the amount by which the value of the asset has been decreased or increased on revaluation should be stated along with the date of revaluation. If considered necessary, he may also comment on the revaluation and its basis.

(b) **Stock** - The value of different types of stocks held (raw materials, work-in-progress and finished goods) and the basis on which these have been valued.

Details as regards the nature and composition of finished goods should be disclosed. Slow-moving or obsolete items should be separately stated along with the amounts of allowances, if any, made in their valuation. For assessing redundancy, the changes that have occurred in important items of stock subsequent to the date of the Balance Sheet, either due to conversion into finished goods or sale, should be considered.

If any stock has been pledged as a security for a loan the amount of loan should be disclosed.

(c) **Sundry debtors, including bills receivable** - Their composition should be disclosed to indicate the nature of different types of debts that are outstanding for recovery; also whether the debts were being collected within the period of credit as well as the fact whether any debts are considered bad or doubtful and the provision if any, that has been made against them.

Further, the total amount outstanding at the close of the period should be segregated as follows:

- (i) debts due in respect of which the period of credit has not expired;
- (ii) debts due within six months; and
- (iii) debts due but not recovered for over six months.

If any debts are due from directors or other officers or employees of the company, the particulars thereof should be stated. Amounts due from subsidiary and affiliated concerns, as well as those considered abnormal should be disclosed. The

recoveries out of various debts subsequent to the date of the Balance sheet should be stated

- (d) **Investments** - The schedule of investments should be prepared. It should disclose the - date of purchase, cost and the nominal and market value of each investment. If any investment is pledged as security for a loan, full particulars of the loan should be given.
- (e) **Secured Loans** - Debentures and other loans should be included together in a separate schedule. Against the debentures and each secured loan, the amounts outstanding for payments along with due dates of payment should be shown. In case any debentures have been issued as a collateral security, the fact should be stated. Particulars of assets pledged or those on which a charge has been created for re-payment of a liability should be disclosed.
- (f) **Provision of Taxation** - The previous years up to which taxes have been assessed should be ascertain. If provision for taxes not assessed appears in be inadequate, the fact should be stated along with the extent of the shortfall.
- (g) **Other Liabilities** - It should be stated whether all the liabilities, actual and contingent, are correctly disclosed. Also, an analysis according to ages of trade creditors should be given to show that the company has been meeting its obligations in time and has not been depending on trade credit for its working capital requirements.
- (h) **Insurance** - A schedule of insurance policies giving details of risks covered, the date of payment of last premiums and their value should be attached as an annexure to the statements of assets, together with a report as to whether or not the insurance-cover appears to be adequate, having regard to the value of assets.
- (i) **Contingent Liabilities** - By making direct enquiries from the borrower company, from members of its staff, perusal of the files of parties to whom any loan has been advanced those of machinery suppliers and the legal adviser, for example, the investigating accountant should ascertain particulars of any contingent liabilities which have not been disclosed. In case, there are any, these should be included in a schedule and attached to the report.

Finally, the investigating accountant should ascertain whether any application for loan to another bank or any other party has been made. If so, the result thereof should be examined.

20. (a) **Advising on Portfolio Management Services:** The Council of the Institute of Chartered Accountants of India (ICAI) pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 has passed a resolution permitting "Management Consultancy and other Services" by a Chartered Accountant in practice. A clause of the aforesaid resolution allows Chartered Accountants in practice to act as advisor or consultant to an issue of securities including such matters as drafting of prospectus, filing of documents with SEBI, preparation of publicity budgets, advice

regarding selection of brokers, etc. It is, however, specifically stated that Chartered Accountants in practice are not permitted to undertake the activities of broking, underwriting and portfolio management Services. Thus, a chartered accountant in practice is not permitted to manage portfolios of his clients.

In view of this, Ravi would be guilty of misconduct under the Chartered Accountants Act, 1949.

- (b) **Advertisement of Professional Attainments:** Clause 7 of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public. Even a member is not permitted to specify the date of setting up of practice or establishment of firm. However, there is no prohibition for printing names of all the three firms on the personal letterheads in which a member holding Certificate of Practice is a partner. Thus Vijay is not guilty of any misconduct under the Chartered Accountants Act, 1949.
- (c) **Developing Website:** As per the guidelines laid down under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 in respect of websites by chartered accountants in practice, it is permitted that website may provide a link to the website of ICAI, its Regional Councils, Branches and Government Departments and other professional Bodies like AICPA, ICAEW, CICA. In this case, M/s ABC Associates provided a link to "All India Chartered Accountants Association" which is not permitted. Hence the firm would be liable for misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.
- (d) **Responding to Tenders:** Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 lays down guidelines for responding to tenders, etc. As per the guidelines if a matter relates to any services other than audit, members can respond to any tender. Further, in respect of a non-exclusive area, members are permitted to pay reasonable amount towards earnest money/security deposits.

In the instance case, since computerization of land revenue records does not fall within exclusive areas for chartered accountants, M/s XYZ can respond to tender as well as deposit ₹ 1,50,000 as earnest deposit and shall not have committed any professional misconduct.