

### **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](http://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 1<sup>st</sup> 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](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](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](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.
  - (a) In the course of the audit of R Ltd., the audit manager of ABC & Co. observed that R Ltd. has outsourced certain activities to an outsourcing agency. As the engagement partner guide the audit manager in the assessment of services provided by the outsourcing agency in relation to the audit.
  - (b) In the course of audit of T Ltd., the audit team is not sure of the possible source of misstatements in the financial statements. As the audit manager identify the sources of misstatements.
  - (c) While auditing Z Ltd., you observe certain material financial statement assertions have been based on estimates made by the management. As the auditor how do you minimize the risk of material misstatements?
  - (d) The management of S Ltd. requests you not to seek confirmation from its debtors. As the auditor of S Ltd., what can be an appropriate response?
2. 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.

**Audit Strategy Planning and Programming**

3. (a) Amu & Co. was appointed as auditor of Great India Ltd. As the audit partner what are the points to be considered while evaluating the "Knowledge of the Business" in the conduct of an audit?
- (b) ABC Ltd. appoints you as the auditor of the company. You observe that previous auditors R & Co., resigned. Also Balance Sheet as at 31-03-2010 shows an audit fee payable of ₹ 45,000. What precautions you will take before commencing the audit work?

**Risk Assessment and Internal Control**

4. You are the auditor of Vishakha Steel Pressing Limited, which manufactures small pressing from sheet-steel. The process generates scrap steel which is placed daily by the work force into a bin kept for that purpose in the yard. Every Friday a lorry arrives from a small local scrap merchant. The bin is loaded on to the lorry and replaced by an empty bin. The weight is obtained by the gatekeeper using the company weighbridge. He notes the weight in a book kept for that purpose in the gate office. Each month a cheque is received through the post from the scrap merchant accompanied by a remittance advice stating the weight of scrap collected, the price and the amount of the cheque. The cheque is banked by the cashier and the remittance advice is filed. There are no other procedures in this area:

You are required to:

- (a) Suggest major improvements to be made in the internal control in this area.
- (b) Suggest key audit procedures under these circumstances to mitigate audit risk.

**Audit under CIS Environment**

5. (a) T & Co which has recently invested in CAAT software wishes to apply the same in the audit of a large public limited company. List the planning activities involved in the use of CAAT.
- (b) "On-line real time processing system and batch processing system have their inherent strengths and weaknesses." Comment.

**The Company Audit**

6. (a) The liability of audit fees of a company has been outstanding since last two years. After having completed the audit for the current financial year, the auditor asked the company to pay his audit fees for all the three years so that audit report of the current year may be handed over to the company. In view of the above, discuss the rights of the auditor to receive the remuneration.
- (b) Special audit can be ordered by the Central government under section 233A of the Companies Act, 1956 if a company sustained losses for two years and the Special Auditor may not be a Chartered Accountant in practice.

7. Comment on the following situations:
- (a) Mr. X, a shareholder of the company pointed out that:
    - (i) The goodwill in the Balance Sheet of the company has appeared on same figure during the past three years.
    - (ii) Premium received on issue of shares prior to the date of balance sheet has been transferred to Profit and Loss account for arriving at the figure of commission payable to the managing director.
  - (b) The Board of Directors of a company have filed a complaint with the Institute of Chartered Accountants of India against their statutory auditors for their failing to attend the Annual General Meeting of the Shareholders in which audited accounts were considered.

#### **Liabilities of Auditors**

8. (a) Explain briefly duties and responsibilities of an auditor in case of material misstatement resulting from Management Fraud.
- (b) Explain the liability of the auditor under section 62 of the Companies Act, 1956, for making an untrue statement in the report (as an expert forming a part of the prospectus).

#### **Audit Report**

9. (a) Under CARO, 2003 how, as a statutory auditor would you comment on the following:
- (i) Fixed assets comprising 1/3<sup>rd</sup> of the total assets have been disposed off during the year.
  - (ii) A Term Loan was obtained from a bank for ₹ 75 lakhs for acquiring R&D equipment, out of which ₹ 12 lakhs was used to buy a car for use of the concerned director, who was looking after the R&D activities.
- (b) There is non- provision in the accounts of a limited company in respect of gratuity liability and auditor's report thereon is silent.
10. As Chartered Accountant you are required to give your reports on various financial statements under Companies Act, 1956 which are as under:
- (i) Report to the shareholders under Section 227;
  - (ii) Report to be set out in prospectus under Section 60(3);
  - (iii) Report to be given to the Central Government as special auditor under Section 233A;
  - (iv) Report to be given on voluntary winding up under Section 488(1).

Explain the significance of each of these reports and your functional approach very briefly.

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

11. Feel Good Bank Ltd. appoints Secure & Co, a firm of Chartered Accountants for a special assignment of ascertaining the quality of its loans and advances portfolio independently. What would be the areas you would focus on such a review?

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

12. The management of Safe Insurance Ltd is not sure about the matters that need to be disclosed under contingent liabilities in its financial statements. As the CFO of the company, guide the management as to what needs to be disclosed under this head.

#### **Cost Audit**

13. "Like every other audit, a systematic planning for cost audit is also necessary". Indicate the matters to be included in a Cost Audit Programme.

#### **Audit under Fiscal Laws**

14. Mr. Ram, the Tax Auditor finds that some payments inadmissible under Section 40 A(3) were made, and advised the client to report the same in form 3CD. The client contends that cash payments were made since the other parties insisted upon the same and did not have Bank Accounts. Comment.
15. Mr. V carries on the business of dealing and export of diamonds. For the year ended 31<sup>st</sup> March 2012, you as the tax auditor, find that the entire exports are to another firm in U.S.A. which is owned by Mr. V's brother.

#### **Audit of Public Sector Undertakings**

16. What is a comprehensive audit of public enterprises? Discuss some of the areas to be examined therein.

#### **Special Audit**

17. (a) State the items contained in the SEBI's check list for auditors in respect of contract notes issued by a Stock Broker.
- (b) You are appointed as an environment auditor in Debt Airways Ltd. Enumerate the main areas to be covered by the auditor in the case of environment audit of an industrial unit.

#### **Internal Audit, Management and Operational Audit**

18. (a) You have been appointed Management Auditor of a large engineering company suffering from a working capital crunch. Discuss broadly the action plan which you would recommend to their management for overcoming their problem.

- (b) RST Ltd, a manufacturing unit does not accept the recommendations for improvements made by the Operational Auditor. Suggest an alternative way to tackle the hostile management.

### Investigation and Due Diligence

19. Sri Ram is above 80 years old and wishes to sell his proprietary business of manufacture of specialty chemicals. Chirag 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 Chirag Ltd.?

### Professional Ethics

20. Comment on the following with reference to the Chartered Accountants Act, 1949, Code of Ethics and Schedules to the Act:
- (a) G & Co., a firm of Chartered Accountants, was appointed as the internal auditor of Easy Ltd., replacing H & Co., another firm of Chartered Accountants, which had expressed their inability to continue as internal auditor to the management through a resignation letter. G & Co. proceeded to conduct the internal audit without communicating with H & Co.
- (b) Mr. I, a CA, had an account with a bank. The normal balance in this account remained at a level below ₹ 25,000. The bank inadvertently credited this account with a cheque of ₹ 2,50,000 belonging to another account holder. When Mr. I came to know about this he withdrew the amount of ₹ 2,75,000 and closed the bank account. After 1 year the bank noticed the mistake and claimed ₹ 2,75,000 with interest. Mr. I contested this claim. Can the bank approach the Institute of Chartered Accountants of India for disciplinary action against Mr. I?
- (c) Ashok Mittal is the auditor of partnership firm consisting of Ram and Shyam as partners. In his audit report to the firm, he did not refer certain materially irregular transactions found in the books of the firm for the reason that Ram, the senior partner approved all such transactions.
- (d) 'While taking Mr. Q as his articled clerk, Mr. R, a practicing Chartered Accountant proposed that the stipend as per regulations will be paid once a year calculated on the monthly rates prescribed by ICAI to which Mr. Q also agreed.

### SUGGESTED ANSWERS/HINTS

1. (a) As per SA 402 "Audit Considerations relating to an Entity Using a Service Organisation", for obtaining understanding of the user entity in accordance with SA 315, the user auditor shall obtain an understanding of how a user entity uses the services of a service organization in the user entity's operation including:



- (i) The nature of services provided by the service organisation and the significance of such services to the user entity, including its effect on the internal control of user entity.
  - (ii) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation.
  - (iii) The degree of interaction between the activities of the service organization and those of user entity and
  - (iv) The nature of the relationship between the user entity and the service organization including the relevant contractual terms for the activities undertaken by the service organisation.
- (b) As per **SA 450 "Evaluation of Misstatements Identified during the Audit"**, misstatements may result from
- (i) An inaccuracy in gathering or processing data from which the financial statements are prepared.
  - (ii) An omission of an amount of disclosure
  - (iii) An incorrect accounting estimate arising from overlooking or clear misinterpretation of facts and
  - (iv) Judgements of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.
- (c) As per **SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"**, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatements for accounting estimates.
- (i) The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.
  - (ii) How Management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed, in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.
  - (iii) The estimation making process adopted by the management including
    - (1) The method, including where applicable the model, used in making the accounting estimates
    - (2) Relevant controls
    - (3) Whether management has used an expert?

- (4) The assumption underlying the accounting estimates
  - (5) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and
  - (6) Whether and, if so, how the management has assessed the effect of estimation uncertainty.
- (d) **SA 505 “External Confirmations”**, establishes standards on the auditor’s use of external confirmation as a means of obtaining audit evidence. If the management refuses to allow the auditor to send a confirmation request, the auditor shall
- (i) Inquire as to Management’s reasons for the refusal, and seek audit evidence as to their validity and reasonableness.
  - (ii) Evaluate the implications of management’s refusal on the auditor’s assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing\* and extent of other audit procedures and
  - (iii) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management’s refusal to allow the auditor to send a confirmation request is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those in charge of governance and also determine its implication for the audit and his opinion.

2. (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.
  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"> <li>• Scope of Review assignments generally falls in agreement between parties</li> </ul>	<ul style="list-style-type: none"> <li>• Scope of Statutory audit should be in accordance with the Companies Act, 1956 or in accordance with other statute.</li> </ul>
<ul style="list-style-type: none"> <li>• Scope of Review assignments are restricted to instructions</li> </ul>	<ul style="list-style-type: none"> <li>• Scope of Statutory audit should be in accordance with Audit Regulations and Norms</li> </ul>
<ul style="list-style-type: none"> <li>• Review assignment should be done in accordance with SREs</li> </ul>	<ul style="list-style-type: none"> <li>• Statutory audit should be conducted in accordance with SAs,<sup>14</sup> Statements and Guidance Notes etc</li> </ul>

REPORT	
Review assignment	Statutory audit
<ul style="list-style-type: none"> <li>• Report of Review Assignment is addressed to the board</li> </ul>	<ul style="list-style-type: none"> <li>• Statutory Audit Report is Addressed to the members</li> </ul>
<ul style="list-style-type: none"> <li>• Format of Report of Review Assignment is wholly discretionary</li> </ul>	<ul style="list-style-type: none"> <li>• Statutory Audit Report is on true and fair view and as per prescribed Format.</li> </ul>
<ul style="list-style-type: none"> <li>• Report of Review Assignment is private report</li> </ul>	<ul style="list-style-type: none"> <li>• Statutory Audit Reports are in public domain</li> </ul>

3. (a) **Points to be considered while evaluating the “Knowledge of the Business”:**  
The broad matters to be considered while obtaining knowledge of business for a new audit assignment are set out in **SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment**. These are:
1. Relevant industry, regulatory, economic and other external factors including the applicable financial reporting framework
  2. The nature of the entity, including:
    - (a) its operations;
    - (b) its ownership and governance structures;
    - (c) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
    - (d) the way that the entity is structured and how it is financed; to enable the

auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

3. The entity's selection and application of accounting policies.
4. The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.
5. The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgement regarding the appropriateness of accounting policies and disclosures.

**(b) Precautions before Commencing the Audit Work:** In the instant case, before accepting the appointment as well as commencing the audit work, the auditor should see the following:

1. When the previous auditor resigned, the auditor should verify that the resolution appointing him as the auditor at the general meeting was duly moved and approved by the shareholders.
2. The auditor should refer to the resignation submitted by the previous auditor.
3. The auditor should communicate with him so as to ascertain.
  - (i) The circumstances which led up to his resignation.
  - (ii) Whether there existed any circumstances on account of which he should not accept the appointment.
  - (iii) Whether the requirements of section 224(6) in respect of such an appointment have been complied with.

Further, Clause (9) of Part I of the First Schedule to Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he 'accepts' an appointment as auditor of a company without first ascertaining from it whether the requirements of Sections 224 and 225 of the Companies Act, 1956, in respect of such appointment have been duly complied with.

**4. (a) Improvements to be made in the internal control in this area:**

- (i) Ensure that all scrap is put into the bin by the work force. This can be achieved by documenting the scrap generated in every production lot/shift/day.
- (ii) Check should be available that the merchant is paying the best prices for the scrap. This can be achieved by getting a quote periodically from few dealers or getting market price and validation.

- (iii) Ensure that quantity collected is paid for this can be achieved by company quantity lifted with the amount paid/quantity for which payment is received.
- (iv) An independent official should attend the weighing and the enter in the book.
- (b) **Key audit procedures under these circumstances to mitigate audit risk:**
  - (i) Budget figures should be prepared for waste and compared to actual waste and variance being investigated
  - (ii) Compare remittance advices/related quantity and reconcile with the quantity in gate keeper's book
  - (iii) Ensure all entries in the weight book is paid for
  - (iv) Ensure all remittance matching entries in the cash book
  - (v) Review the reasonableness of total scarp sold during the period by comparing with manufacturing records of steel used in processing.
- 5. (a) **T & Co should consider the following planning activities in the use of CAAT:**
  - (1) set the objective of CAAT application;
  - (2) determine the content and accessibility of the entity's files;
  - (3) identify the specific files or databases to be examined;
  - (4) understand the relationship between the data tables where a database is to be examined;
  - (5) define the specific tests or procedures and related transactions and balances affected;
  - (6) define the output requirements;
  - (7) arrange with the user and IT departments, if appropriate, for copies of the relevant files or database tables to be made at the appropriate cut off date and time;
  - (8) identify the personnel who may participate in the design and application of CAAT;
  - (9) refine the estimates of costs and benefits;
  - (10) ensure that the use of CAAT is properly controlled;
  - (11) arrange the administrative activities, including the necessary skills and computer facilities;
  - (12) reconcile data to be used for CAAT with the accounting and other records;
  - (13) execute CAAT application;
  - (14) evaluate the results;

- (15) document CAATs to be used including objectives, high level flowcharts and run instructions; and
- (16) assess the effect of changes to the programs/system on the use of CAAT.

(b) **On-line Real Time Processing System vs. Batch Processing System** In an on-line real-time (OLRT) processing system, transactions are entered as they occur, and are processed as they are entered. These systems form the heart of management information systems. Given the continuous updating of the database as transactions are entered, the status of such files as accounts receivable, accounts payable, and inventory may be determined at any time. In an on-line real-time processing system, individual transactions are entered at terminal devices, validated and used to update related computer files immediately. An example is the application of cash receipts directly to customers' accounts. The results of such processing are then available immediately for inquiries or reports.

In a system with on-line batch processing, individual transactions are entered at a terminal device, subjected to certain validation checks and added to a transaction file that contains other transactions entered during the period. Later, during a subsequent processing cycle, the transaction file may be validated further and then used to update the relevant master-file. For example, journal entries may be entered master-file being updated on a monthly basis. Inquiries of, or reports generated from, the master-file will not include transactions entered after the last master-file update. In a batch processing system which is not on-line, transactions are accumulated and processed in group sales orders for the day, invoices to be recorded, and daily cash receipts might each be viewed as a "batch" of transactions, to be processed as a group. Batch processing systems are distinguished by their relative simplicity and reliability. They do not process transactions as quickly as the more advanced systems, nor do they possess the potential for providing timely information concerning the files updated by transactions processing. Given these limitations, the use of networked PCs terminals has become widespread, even among small entities. Batch processing systems are rarely found in today's systems environment.

Although powerful in terms of information capability, OLRT systems are more complex than batch processing systems. Moreover, they ordinarily do not provide the extent of audit trail documentation produced by batch system and for this they are more difficult to audit in terms of obtaining satisfaction concerning the existence of necessary controls, and of designing substantive testing procedures.

Conversely, in a batch processing system, the transaction are accumulated and processed in batches or groups. Control totals, both monetary and documentary, are also available for review to ensure completeness and accuracy of data being processed. The system is simple and reliable. However, its deficiency lies in the

MIS is not updated on a concurrent basis and, therefore, information is not available on a timely basis.

Accordingly, it is a question of cost-benefit analysis as to which system will be more preferable to an entity.

6. (a) Section 224(8) of the Companies Act, 1956 deals with fixation of remuneration of an auditor. However, the Act is silent on the mode of recovery of remuneration by an auditor. Normally speaking, an auditor has right to receive his remuneration after completing his work, that is, submission of the audit report. As per Expert Advisory Committee of the Institute, the auditor may also recover his fees on progressive basis.

In the instant case, perhaps, the auditor has linked the delivery of audit report only on an audit fees being received since the payment has been outstanding for last two years. But as a matter of professional ethics it would not be proper on part of auditor and moreover he would not be performing his duties under the companies Act 1956 if he links delivery of the audit report conditional upon receipt of audit fees. As such it would be better on the part of the auditor to enforce his right to receive remuneration through court of Law only after submitting his report.

- (b) Special Audit under section 233A of the Companies Act, 1956 can be ordered by the Central Government, if it is of the opinion –
- (i) That the affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices; or
  - (ii) that any company is being managed in a manner likely to cause serious injury or damage to the interests of trade, industry or business to which it pertains; or
  - (iii) that the financial position of any company is such as to endanger its solvency.

In view of the aforesaid, mere incurrence of losses continuously for two years may not be a valid ground for ordering special audit unless the solvency of the company is endangered. Therefore, this proposition is false. However this section empowers the Central Government to appoint a Chartered Accountant (whether or not such chartered accountant is in practice) or the company's auditor himself to conduct the special audit.

Further the said section also provides that for the purpose, it may appoint a chartered accountant, whether or not the chartered accountant is in practice, or the company's auditor itself to conduct such special audit. Hence second part of the proposition is true.

7. (a) (i) As per the provisions of AS 26 "Intangible Assets", an intangible assets should be carried in the books at cost less accumulated amortization and accumulated impairment losses. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There



is a reputable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use according to Para 63 of AS 26.

In the given case, the company has not amortized any value of goodwill since past three years. The auditor should have indicated this fact in his report that no amount of goodwill has been written off during the past three years.

- (ii) Premium received on issue of shares is capital receipt and should not be credited to profit and loss account. As per the provisions of Section 349 of the Companies Act, 1956, premium on issue of shares should not be considered in computation of net profit for the purpose of managerial remuneration. The auditor should have qualified the audit report and qualified the amount by which the profit stands inflated.
- (b) **Auditor's Attendance at Annual General Meeting:** Section 231 of the Companies Act, 1956 confers right on the auditor to attend the general meeting.

The said section provides that all notices and other communications relating to any general meeting of a company which any member of the company is entitled to have are also to be forwarded to the auditor. Further, it has been provided that the auditor shall be entitled to attend any general meeting and to be heard at any general meeting which he attends on any part of the business which concerns him as an auditor.

Therefore, the section does not cast any duty on the auditor to attend the annual general meeting. The law only confers right on the auditor to receive notices and also attend the meeting if he so desires. Therefore, the complaint filed by the Board of Directors is based on mis-conception of the law.

8. (a) **Duties & Responsibilities of an auditor in case of Material misstatement resulting from management fraud:** Misstatement in the financial statements can arise from fraud or error. The term fraud refers to an 'Intentional Act' by one or more individuals among management, those charged with governance. The auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements.

Fraud involving one or more members of management or those charged with the governance is referred to as "management fraud". The primary responsibility for the prevention and detection of fraud rests with those charged with the governance and the management of the entity.

Further an audit conducted in accordance with the standards on auditing generally accepted in India, is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatements whether caused by error or fraud. The fact that an audit is carried out may act as deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of financial statements will not be detected, even though the audit is properly planned and performed in accordance with the standards on auditing generally accepted in India. An audit does not guarantee that all material misstatement will be detected because of such factors, as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.

Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees. Auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, hence in an audit, the auditor does not guarantee that material misstatements will be detected.

- (b) **Liability of the auditor under Section 62 of the Companies Act, 1956:** Section 62 of the Companies Act, 1956 deals with civil liability for mis-statements in the prospectus. An Action in this case can be brought by a person who has sustained a loss or damage as a result of subscription to the shares or debentures, on the faith of the prospectus containing an untrue statement

The liability would arise if the written consent of the auditor to the issue of the prospectus, including the report purporting to have been made by him as an "expert" has been obtained.

The action would not succeed if the auditor is able to prove:

- (i) that after he had given his consent in writing, the same was withdrawn before any copy of the prospectus was delivered for registration; or
- (ii) that after registration of the prospectus but before any allotment was made thereunder, he, on realizing that the statement was untrue, had withdrawn his consent in writing and had given reasonable public notice of the withdrawal and of the reasons therefore; or
- (iii) that he was competent to make the statement and that on reasonable ground he believed and had continued to believe upto the time of allotment of shares or debentures that the statement was true.

9. (a) **Reporting under CARO, 2003 :**

- (i) **Disposal of Fixed Assets:** Under CARO, 2003, an auditor is required to state if substantial part of the fixed assets have been disposed off during the year, whether it has affected the going concern. This clause requires the auditor to carry out adequate audit procedures to satisfy himself that the company shall be able to continue as going concern for the foreseeable future despite the sale of substantial part of the fixed assets.

Accordingly, in the instant case, the auditor should satisfy himself as to

whether disposal off of 1/3<sup>rd</sup> of fixed assets during the year had any effect on the going concern assumption on account of such sale of fixed assets. The auditor is required to exercise his professional judgement to determine whether disposal off of one-third of total assets constitutes substantial part or not. Depending upon the judgement arrived at by the auditor, he shall report whether substantial part of fixed assets have been disposed off or not during the year and it has affected or not affected the going concern status of the company. Alternatively, in case the auditor is of the opinion that it constitutes substantial sale but the going concern assumption is appropriate because of mitigating factors then he has to ensure that the same are disclosed in the financial statements or else he shall have to modify the auditor report. The manner of reporting shall also be modified appropriately in case the going concern assumption is resolved or not.

- (ii) **Utilisation of Term Loans:** Under CARO, 2003, an auditor is required to comment whether term loans were applied for the purpose for which the loans were obtained.

The auditor should examine the terms and conditions of the term loan with the actual utilisation of the loans. If the auditor finds that the fund has not been utilized for the purpose for which they were obtained, the report should state the fact.

In the instant case, since term loan taken for the purpose of R&D equipment has been utilized for purchase of car which has no relation with R&D equipment. Therefore, car though used for R&D Director cannot be considered as R&D equipment. The auditor should state the fact in his report that the out of term loan of R&D ₹ 12 lakhs was not utilised for the purpose of acquiring the R & D equipment.

- (b) Section 209(3) states that a company shall not be deemed to be maintaining proper books of account in case such books are not kept on accrual basis, according to the double entry system of accounting. If no provision is made, a note should be given on the accounts disclosing the total accrued liability of gratuity and the amount not provided for, otherwise the auditor should qualify his report.

Accordingly, the auditor should include this paragraph in his report to qualify true and fair view of both the balance sheet and the profit and loss account. Failure of the management to quantify the amount of the liability by resorting profit to actuarial valuation should also be included in the qualification

#### 10. Auditor's report on the Companies Act, 1956 (the Act)

- (i) **Report to Shareholders under section 227:** Section 227 of the Act, 1956 lays down powers and duties of the auditor. Sub-sections (2), (3), (4) and (4A) of Section 227 deals with the reporting requirements. Sub-section (2) states that the auditor of

a company shall make a report to the members on the accounts examined by him and on every balance sheet and profit and loss account which are laid before company in general meeting during the tenure of his office. The significance of the report lies in the fact that it requires that the report shall state whether in his opinion and to the best of his information and according to the explanations given to him the said accounts give the information required by the Act in the manner so required and give a true and fair view.

The functional approach by the auditor for making a report under section 227 of the Act, requires him to perform compliance and substantive audit procedures to verify the information contained in the financial statements. Having regard to the materiality of the items involved, the auditor also determines whether the relevant information is properly disclosed in the financial statements.

- (ii) **Report to be set out in the prospectus under section 60(3):** Section 60(3) of the Act provides that a prospectus should be accompanied *inter alia* by the consent in writing of the person named therein as the auditor of the company or intended company, to act in that capacity. Part II of Schedule II to the Act prescribes the reports to be set out in a prospectus. The report contains particulars about profit and losses of the company for five preceding year, assets and liabilities, rates of dividend, etc. The significance of the report lies in the fact that a prospectus is issued by a company when it seeks to raise funds from the public and gives detailed information about the company to enable prospective investors to take a well-informed decision. The functional approach on the part of auditor involves obtaining information from the management, particularly, in respect of estimation of current and future profits. He has to also ensure that all adjustments have been made properly.
- (iii) **Special Audit Report under section 233A:** Under section 233A of the Act, the Central Government has a power to order a special audit of the accounts of a company for a specified period. An order to conduct special audit of the accounts of a company may be made where the Central Government is of the opinion that:
  - (a) the affairs of the company are not being managed in accordance with sound business principles or prudent commercial practices; or
  - (b) the company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or
  - (c) the financial position of the company is such as to endanger its solvency.

The main objective of such an audit is to provide a critical review of the company's working and state of affairs to the government. Special audit should be distinguished from 'investigation' into the affairs of a company under section 235 of the Act. The special auditor has the same powers and duties which a company

auditor has under section 227 of the Act, with the difference, however, the instead of making his report to the members of the company, the special auditor makes the report to the central government. The special audit report should, as far as possible, include all the information required to be included in an audit report under section 227 of the Act. However, the central government may direct that the special audit report shall also include a statement on any other matter referred to the special auditor by the government.

**(iv) Report on the accounts prepared on voluntarily winding up under section 488**

**(1):** Section 488(1) of the Act requires that where it is proposed to wind up a company voluntarily, its directors, or in case the company has more than two directors, the majority of the directors, may at a meeting of the Board, make a declaration verified by an affidavit, to the effect that they have made a full inquiry into the affairs of the company, and that, having done so, they have formed the opinion that the company has no debts, or that it will be able to pay its debts in full within such period not exceeding three years from the commencement of the winding up as may be specified in the declaration. Such declaration has to be accompanied by a copy of the report of the auditors of the company (prepared, as far as circumstances admit, in accordance with the provisions of this Act) on the profit and loss account of the company for the period commencing from the date up to which the last such account was prepared and ending with the latest practicable date immediately before the making of the declaration and the balance sheet of the company made out as on the last mentioned date and also embodies a statement of the company's assets and liabilities as at the date.

11. Secure & Co should focus on the following aspects in the review of loans and advances portfolio of Feel Good bank:

Whether

1. The Advances made after ascertaining the credit worthiness of the borrower and released after proper sanction.
2. All necessary documents like agreements demand promissory notes, letter of hypothecation etc., have been properly obtained and appropriately stamped.
3. The Borrower has complied with all the terms of sanction.
4. Sufficient margins have been kept against the security.
5. The securities are in possession of the bank are in safe custody of two or more officials.
6. The loan accounts have been operated within the sanctioned limits/ drawing power and wherever excess whether they are properly reported and recovered promptly.
7. Surprise checks on the assets hypothecated to the bank done,
8. The operation of the account is reviewed at least one a year.

9. The market value of the security given ascertained periodically.
  10. Adequate insurance is taken in respect of the assets that are offered as security.
  11. The borrower submits periodic stock and book debts statements where the facilities are secured against them and whether a review is done to ensure non-moving, obsolete, unrealizable debtors are removed from the same.
  12. The financials of the borrower are periodically obtained and reviewed for any sign of credit risk.
12. The following needs to be disclosed by Safe Insurance Ltd In its financial statements
- Contingent liabilities on account of
- Partly paid investments
  - Underwriting commitments outstanding
  - Claims, other than those under policies, not acknowledged as debts
  - Guarantees given by or behalf of the company
  - Statutory demand /liabilities in dispute, not provided for
  - Reinsurance obligations to the extent not provided for in accounts
  - Others (if any to be specified)
13. **Matters to be included in Cost Audit Programme:** It is a true statement that like any other audit a systematic planning for cost audit is also necessary. Therefore, the cost audit programme should include all the usual broad steps that a financial auditor includes in his audit programme. This would require that the various aspects like what to be done, when to be done and by whom to be done are adequately taken care of. However, looking to the basic difference in cost audit and financial audit as allocation and apportionment of expenses, statutory requirement etc. should require special consideration. Cost audit, in order to be effective, should be completed at one time as far as practicable. Based on above factors a set of procedures and instructions are evolved which may be termed the cost audit programme. Matters to be included in the Cost Audit Programme may be divided into following two stages:
- (a) **Review of Cost accounting record will include:**
- (i) Method of costing in use - batch, process or unit.
  - (ii) Method of accounting for raw materials; stores and spares, wastages, spoilage defectives, etc.
  - (iii) System of recording wages, salaries, overtime and spares, wastages, etc.
  - (iv) Basis of allocation of overheads to cost centres and of absorption by products and apportionment of service department's expenses.
  - (v) Treatment of interest, recording of royalties, research and development

expenses, etc.

- (vi) Method of accounting of depreciation.
- (vii) Method of stock-taking and its valuation including inventory policies.
- (viii) System of budgetary control.
- (ix) System of internal auditing.

**(b) Verification of cost statement and other data will mainly cover:**

- (i) Licensed, installed and utilised capacities.
- (ii) Financial ratios.
- (iii) Production data.
- (iv) Cost of raw material consumed, wages and salaries, stores, power and fuel, overheads provision for depreciation etc.
- (v) Sales realisation.
- (vi) Abnormal non-recurring and special costs.
- (vii) Cost statements.
- (viii) Reconciliation with financial books.

Some other factors which need to be brought into cost audit programme includes system of cost accounting, range of products, areas to be covered etc. indicating allocation of manpower and the time to be taken for completing the audit.

- 14. Form 3 CD:** The audit under section 44 AB of the Income Tax Act 1961 requires that the tax auditor should report whether in his opinion the particulars in respect of Form 3CD are true and correct. It is the primary responsibility of the assessee to prepare the information in form 3 CD. The auditor has to examine whether the information given is true and correct. The form 3 CD is not a report of Tax Auditor. The report is in the form of 3 CA or 3 CB depending on the nature of the organization of the entity. If the tax auditor is satisfied that the information contained in form 3 CD is true and correct then he can give unqualified report in form 3 CA or 3 CB saying "in my opinion and to the best of my information and according to the explanations given to me and considering the materiality the particulars given in form 3 CD are true and correct." But in the given case the tax auditor has found that the form 3 CD contains the incomplete, misleading and false information.

Disallowance under section 40A(3) is attracted if the assessee incurs any expenses in respect of which payment of aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on bank or account payee draft exceeds ₹ 20,000/- . However, exemption is provided in respect of certain expenditure in Rule 6DD. In such cases, disallowance under section 40A (3) would not be attracted.

Under clause 17 (h) of Form 3CD, amounts inadmissible under section 40A (3), read with Rule 6DD, have to be reported. Cash payment made on insistence of other parties on the contention that they do not have bank accounts is not covered under the list of exceptions provided under Rule 6DD.

Mr. Ram has to report the payments inadmissible under section 40A (3) under clause 17(h) of Form 3CD.

15. Clause 18 of form 3CD, annexed to the tax audit report in Form 3CA/3CB, requires the tax auditor to specify particulars of payments made to person specified u/s 40(A)(2)(b) of the Income Tax Act 1961. Persons specified in the said section are relatives of an assessee and sister concerns, etc. In the instant case, however, Mr. V has not made any payments to his brother. On the contrary, he must have received payments from him against exports made and, thus, this clause would be required to verify whether the exports are genuine, i.e. , whether the diamonds have been delivered by verifying the necessary delivery documents, relevant invoices, etc., the reasonableness of the price and whether the export realization have been received
16. **Comprehensive Audit of Public Enterprises: Areas to be examined:** The scope and extent of audit of public sector enterprises is determined by the Comptroller and Auditor General of India. Audit of public enterprises in India is not restricted to financial and compliance audit; it extends also to efficiency, economy and effectiveness with which these operate and fulfil their objectives and goals. Another aspect of such audit relates to questions of propriety; this audit is directed towards an examination of management decisions in sales, purchases, contracts, etc. to see whether these have been taken in the best interests of the undertaking and conform to accepted principles of financial propriety. Comprehensive audit involves assessing efficiency and effectiveness of public enterprises in its entirety to be conducted on the basis of certain standards and criterion. Public enterprises have been set-up with socio-objectives. An objective assessment with reference to such objectives fulfillment would require comprehensive audit.

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

The areas covered by comprehensive audit are those of investment decisions, project formulation and management, organisation, delegation of powers and management



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

- Comparison of overall capital cost of the project with the approved planned costs.
- Production or operational outputs vis-a-vis under-utilisation of the installed capacity.
- Systems of project formulation and implementation.
- Planned rate of return
- Cost control measures.
- Research and development programmes.
- System of repairs and maintenance.
- adequate purchase policies
- Effective and economical procedures
- Project planning
- Undue waste, unproductive time for men and machines, wasteful utilisation or even non-utilisation of resources

**17. (a) 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.

**(b) Main areas to be covered in the case of environment audit of an industrial unit**

- (i) **Layout and Design** – The layout to be sketched in the style which will allow adequate provisions for installing pollution control devices, as well as provision for up-gradation of pollution control measures and the meeting of the requirements of the regulations framed by the Government. In the course of the audit, the area which requires attention but not attended to by the industry to be pinpointed as well as the future requirements of the environmental measures required in commensuration with the proposed future course of working plan are to be identified.
- (ii) **Management of Resources** – Management of resources includes air, water, land, energy, raw materials and human resources besides others. The use of all resources is interlinked and the best uses in a synchronised manner results the best output and minimum waste. The waste of resources to the minimum possible extent is good for the health of the industry as well as the environment.
- (iii) **Pollution Control System** – An effective system of pollution control should be in existence. One aspect should be whether all required pollution control measures are in vogue or not next aspect should be whether the same is effective or not, further it is to investigate, whether more measures are required, keeping in view the type of industry and its nature of working with respect to its grade of polluting the environment.
- (iv) **Emergent Safety Arrangement** – The chemical, gas, etc., industries which are prone to sudden requirement of safety arrangements, must remain alert all the while. The emergency plans are to be reviewed periodically; sufficient staff alongwith other required safety amenities should be kept ready. The staff, so engaged, must possess the required awareness and alertness to meet the contingency. The degree of awareness, however, can be upgraded with proper training provisions.
- (v) **Medical & Healthcare Facilities** – The medical services should be maintained. The health of the workers should be a big consideration for the management.
- (vi) **Industrial Hygiene** – Proper system should be in vogue to eliminate industrial unhygienic state.
- (vii) **Occupational Health** – The requirement for safeguarding against occupational health hazards should be available for all the workers. As the occupational health hazards vary from industry to industry due to the difference in the nature of working atmosphere and the pollutants present in it, the concerned industry must pay proper weightage to those diseases which are prone to that particular type of industry.

- (viii) **Information Assimilation and Reporting System** – The information system should be strengthened to generate the authenticity and its reporting system should be proper, keeping in view, the authorities, responsibilities and subsequent delegations. A report of compliance of all statutory environmental laws along with other preventive and precautionary measures should be put to Board at regular intervals.
  - (ix) **EIA Methodology** – The Environmental Impact Assessment (EIA) is usually a pre-requisites to start an industry. This is done considering the known spheres of activities on the existing environmental conditions. But the predictions necessarily deviate from the actual happenings when the industry starts working. To accommodate the deviation in the system is also to be incorporated in the EIA report, if it is noticed that the degradation to the environment caused on the establishment and running of the industry is much higher than what was predicted, the mitigatory measures suggested must also be furthered.
  - (x) **Compliance to the Regulatory Mechanism** – As the persons who are directly working with the system, may be unaware of the latest developments and requirements for the compliance of stipulations and standards prescribed by the various regulatory authorities, they should be trained and instructed on regular basis, to avoid making the Board/owner vulnerable to prosecution and penalty.
  - (xi) **Concern for the Society** – The industry very often transforms the agrarian environment into an industrial environment. The people so displaced by industrialisation feel alienated and develop a feeling of facing the gaseous, dustful, clumsy state of surroundings. The audit should look into this aspect how the industry is making a balance between its own development and the society's concern
18. (a) **Organizing a Management Audit for working capital crunch:** Adequate amount of working capital for the smooth running of the concern is required but it should not allow the working capital to remain idle unduly. If a company can manage the working capital efficiently, there will be neither liquidity problem nor will there remain idle fund. Keeping this significant factor in view and to ensure an adequate flow of working capital to the concern, the following action plan may be considered :
- 1. Preparation of budget in respect of sales, production, expenses, capital expenditure, working capital and ultimately a Master Budget consisting of projected Profit and Loss, Balance Sheet and Funds Flow Statements to estimate the requirement of working capital well in time.
  - 2. Preparing the cash budget on month to month basis showing inflow and outflow of cash and the financing of the shortfall either by way of bank borrowing or from other financial institutions pending approval of the increased

limit and release of funds by the banker. In case, there is a shortfall or an excess accumulation of fund over the budget due to unforeseen circumstances coupled with imbalance in inventory holding for reasons beyond control or the working capital position is disturbed in inventory holding for reasons beyond control or the working capital position is disturbed by some extraneous factors such as unusual delay in approval of supplies by the purchasing company, strike in transportation agencies, shortage of wagon delay in realisation of payments from customers, ad-hoc allotment of controlled items, then financial support from some other sources is essential so as to maintain the growth and activity in terms of the budgeted targets.

3. Being an engineering industry, the base raw materials like steel whose supplies may not be regular and not in uniform order. Therefore, in all such cases inventories should be classified properly to determine the level of stock of materials. The control over inventory where possible should strictly be maintained as sometimes it is noticed the holding of inventory generally goes up due to mismatch between supplies of materials and unplanned allotment of controlled materials.
4. Minimum work in progress should be maintained and for the purpose it is necessary to ensure that no bottlenecks develop at any stage during the production process.
5. The management must decide the optimum credit period which may really be the period in which the customers of the concern are able to dispose of the goods and realise the proceeds.
6. To obtain timely support from banks, a good amount of preplanning and follow-up action is necessary. Returns should be submitted in time so that review of the case may be made within least possible time and the cash credit requirements be finalised and sanctioned within the minimum loss of time.
7. In respect of collections, which can be improved by taking up proper follow up steps even where documents are presented through bank and waiting clearance. Where outstation cheques for large amounts are received against supplies the clearing of cheques take more than 25 to 30 days and instead if someone is deputed alongwith a letter of authority to the customer with a request to pay by bank demand draft at the cost of the company then the money can be realised within a week or so that any collection at the end may be credited to the deposit accounts for onward transmission to the main office.
8. Payment to creditors is another area which should be critically scrutinized to control over the average of the trade credit. Financial management is responsible for not only maintaining credit standing of the company but also for generating necessary credit financing. Purchase of raw materials should be arranged in sequence related to production requirements to avoid blockage of

funds. Besides as stated above, scientific production planning and scheduling is absolutely necessary to reduce the conversion time and to minimise blockage of inventory by way of semi-finished goods.

- (b) **Alternative way to tackle the hostile management:** While conducting the operational audit the auditor has to come across many irregularities and areas where improvement can be made and therefore he gives his suggestions and recommendations.

These suggestions and recommendations for improvements may not be accepted by the hostile managers and in effect there may be cold war between the operational auditor and the managers. This would defeat the very purpose of the operational audit.

The Participative Approach comes to the help of the auditor. In this approach the auditor discusses the ideas for improvements with those managers that have to implement them and make them feel that they have participated in the recommendations made for improvements. By soliciting the views of the operating personnel, the operational audit becomes co-operative enterprise.

This participative approach encourages the auditee to develop a friendly attitude towards the auditors and look forward to their guidance in a more receptive fashion. When participative method is adopted then the resistance to change becomes minimal, feelings of hostility disappear and gives room for feelings of mutual trust. Team spirit is developed. The auditors and the auditee together try to achieve the common goal. The proposed recommendations are discussed with the auditee and modifications as may be agreed upon are incorporated in the operational audit report. With this attitude of the auditor it becomes absolutely easy to implement the proposed suggestions as the auditee themselves take initiative for implementing and the auditor do not have to force any change on the auditee.

Hence, Operational Auditor of RST Ltd. manufacturing unit should adopt above mentioned participative approach to tackle the hostile management of RST Ltd.

19. A due diligence audit on behalf of Chirag Ltd. with a view to acquiring the business shall involve following steps:

- (a) **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

- (b) **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.

- (c) **Review of Financial Statements** - Before commencing the review of each of the aspect covered by the financial statements, the accountant should examine whether 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.

- (d) **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.

- (e) **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?

- (f) **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 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.

- (g) **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.

- (h) **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 existence 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.
  - (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.
20. (a) As per Clause 8 of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice will be deemed to be guilty of professional misconduct if he accepts a position as an auditor previously held by another chartered accountant or a certified auditor who has been issued certificate under the Restricted Certificate Rules, 1932 without first communicating with him in writing. The Council has also laid down that the requirement for communicating with the previous auditor being a Chartered Accountant in practice would apply to all



types of audit viz., statutory audit, tax audit, internal audit, concurrent audit or any other kind of audit. Accordingly G & Co. will be deemed to be guilty professional misconduct.

- (b) As per Clause 2 of Part IV of First Schedule of The Chartered Accountant Act, 1949, a Chartered Accountant will be deemed to be guilty of other misconduct if he in the opinion of the Council brings disrepute to the profession or the Institute as a result of his action whether or not related to his professional work.

In the instant case, Mr. I, a CA, had an account with a bank from which he withdrew the amount of ₹ 2,75,000 and closed the account. This amount of ₹ 2,75,000 was pertaining to ₹ 25,000 minimum balance and ₹ 2,50,000 belonging to other account holder and inadvertently credited to his account by the bank. The act of Mr. I will certainly bring disrepute to the profession. Hence under this clause the bank can file a suitable complaint with The Institute of Chartered Accountants of India.

- (c) As the transactions passed through the books of accounts are materially irregular, their non-disclosure makes the financial statements misleading. Clauses 5 and 6 of Part I of Second Schedule of The Chartered Accountant Act, 1949, states that a chartered accountant would be deemed to be held guilty of misconduct in case he fails to disclose a material fact known to him which is not disclosed in the financial statements or fails to report on a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity. Therefore as per both these clauses, the auditors would be deemed to be guilty of professional misconduct. In case of partnership firm partners are jointly and individually liable hence Ram and Shyam both are responsible

- (d) As per Clause 1 of Part 2 of Second Schedule of The Chartered Accountant Act, 1949, a chartered accountant shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of the CA (Amendment) Act 2006 or the regulation; made thereunder or any guidelines issued by the Council:

As per Regulation 48 stipend to Articled Assistant should be paid on a monthly basis.

In the instant case, Mr. R, a practicing chartered accountant, proposed that the stipend as per regulations will be paid once a year calculated on the monthly rates prescribed by the ICAI, he will be deemed to be guilty of professional misconduct because of non payment of stipend on monthly basis even though his article clerk also agreed to his proposal.