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PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

Question No. 1 is compulsory

Answer any **five** *from the rest*

Question 1

(a) *A Ltd is a manufacturer of readymade garments. It sells its products to franchisees located across the country. Readymade garment industry is subject to change in trends of fashion and as such, some of the goods are returned and A Ltd accepts them back as sales returns. On the basis of past trends such returns are estimated to be at 20% of the sales of any year. For the financial year 2011-12, A Ltd had accounted for the actual sales return made upto 31st March 2012 but has not reversed the possible expected return that are likely to happen after 31st March 2012, in respect of the sale made for the FY 11-12. Mr. X the auditor of A Ltd wants this to be considered in the accounts for the year ended on 31st March 2012 but the company is of the opinion that although there is a probability of some goods being returned by the franchisees, there is no significant uncertainty regarding the amount of consideration that will be derived from the sale of goods, since the goods are not in the possession of the company and risk and rewards of ownership still lie with the franchisees and the company cannot record sales returns in its books of account in respect of goods that are likely to be received after the date of balance sheet. Comment.* *(5 Marks)*

(b) *R & Co. is the statutory auditor of S Ltd. For the financial year ended on 31st March 2012, S Ltd had disclosed in the notes (Note No. X) "The state pollution control board had ordered the closure of the company's only manufacturing plant on the ground that it is environmentally damaging, which the company had challenged in a law suit. Pending the outcome of the law suit the financial statements are prepared on a going concern basis". Further the financial statements prepared by the management of S Ltd include financial statements of certain branches which are audited by other auditors. What are the reporting responsibilities of R & Co ?* *(10 Marks)*

(c) *In the course of the statutory audit of Z Ltd, its statutory auditors, having determined that the work of internal auditor is likely to be adequate for the purpose of statutory audit, wanted to use the work of internal auditor in respect of physical verification of fixed assets. How an evaluation of this specific work done by the internal auditor can be done?*

(5 Marks)

Answer

(a) **Recognition of Revenue:** AS 9 on 'Revenue Recognition', states that revenue from sale of goods should be recognised when the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership and no significant uncertainty exists regarding the amount of consideration.

Further, revenue recognition is mainly concerned with the timing of recognition of revenue in statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by the agreement between the parties involved in the transaction. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

In the present case, A Ltd. is a manufacturer of readymade garments and sells its products to franchisees located across the country. Due to change in trends of fashion etc sold goods are being returned and A Ltd. accepts them back as sales returns. On the basis of past trends such returns are estimated as 20% of the sales of any year.

In this case, the company is bearing the risk of sales return and therefore, the company should not recognize the revenue to the extent of 20% of its sales. The company may disclose suitable revenue recognition policy in its financial statements separately.

In the absence of the above, the auditor must qualify his report.

Note: Alternative Answer is possible on the basis of AS 29 on Provisions, Contingent Liabilities and Contingent Assets by recognising the whole sales as revenue, i.e., 100% accounted in profit or loss account as Sales Income as there is no significant uncertainty regarding the amount of consideration. However, keeping in view its past performance, A Ltd. should make a provision for sales income which is not likely to realise. In the absence of the above, the auditor will have to qualify his report.

(b) Reporting Responsibilities of Statutory Auditor: This question involves two broad aspect with respect to reporting requirements i.e. (i) one which deals with Going Concern aspect where the company has gone for legal suit and (ii) other is work done by other auditors.

As per facts of the case, the State Pollution Control Board has issued the closure order for S Ltd., on account of environmental damaging by its only manufacturing plant. However, S Ltd had challenged the same by way of a law suit. Due to pendency of the outcome of the legal suit, the company has prepared its financial statements on going concern basis.

As per SA 570 "Going Concern", under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions.

The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. For this the auditor may take the help of expert.

As per SA 620, "Using the Work of an Auditor's Expert", if expertise in a field is necessary to obtain sufficient appropriate audit evidence, he may determine to use the work of an auditor's expert. On the basis of expert's opinion he may decide to rely or not on assessment of management.

As per SA 570 Going Concern, pending legal proceedings is a condition that, individually, may cast significant doubt about the going concern assumption. Existence of above condition signifies that a material uncertainty exists.

Further, when the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

(i) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(ii) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph as per SA 706 "Emphasis of matter paragraphs and other matters paragraph in the Independent Auditor's Report", in the auditor's report to:

(a) Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and to

(b) Draw attention to the note in the financial statements that discloses the matters

In the present situation, management of S Ltd. had disclosed the above fact in the financial statement. Further, use of the going concern assumption is appropriate but a material uncertainty exists so assuming the assessment and disclosure of S Ltd. in order, R & Co. should include an Emphasis of Matter paragraph in the auditor's report.

As per Sec. 227 of the Companies Act, 1956, the auditor has to state that whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.

Further, as per SA 600 Using the work of Another Auditor, When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/ branches/ subsidiaries or other components audited by other auditors.

Note : Alternative answer is possible assuming that company is not going concern, hence auditor should issue adverse report.

(c) Evaluation of Specific Work Done by Internal Auditor: The statutory auditor should as a part of his audit, carryout general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor.

As per SA 610 “Using the Work of Internal Auditors ", the nature, timing and extent of the audit procedures performed on specific work of the internal auditors will depend on the external auditor’s assessment of the risk of material misstatement, the evaluation of the internal audit function, and the evaluation of the specific work of the internal auditors. Such audit procedures may include examination of items already examined by the internal auditors, examination of other similar items; and observation of procedures performed by the internal auditors.

Further, to determine the adequacy of specific work performed by the internal auditors for the external auditor’s purposes, the external auditor shall evaluate whether:

(1) The work was performed by internal auditors having adequate technical training and proficiency;

(2) The work was properly supervised, reviewed and documented;

(3) Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;

(4) 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

(5) Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

Question 2

Give your comments with reference to the Chartered Accountants Act, 1949 and Schedules thereto.

(a) Z, a practicing Chartered Accountant issued a certificate of circulation of a periodical without going into the most elementary details of how the circulation of a periodical was being maintained i.e. by not looking into the financial records, bank statements or bank

pass books, by not examining evidence of actual payment of printers bills and by not caring to ascertain how many copies were sold and paid for. *(4 Marks)*

(b) *X, a practicing Chartered Accountant in an application for permission to study submitted by his Articled Assistant to the council had confirmed that the normal working hours of his office were from 11 A.M. to 6 P.M. and the hours during which the Articled Assistant was required to attend classes were 7.00 A.M. to 9.30 A.M. According to the information from College, the Articled Assistant attended the College from 10 A.M. to 1.55 P.M. on all week days. About the Articled Assistant attending the classes even during office hours, X pleaded ignorance.* *(4 Marks)*

(c) *K, a practicing Chartered Accountant gave 50% of the audit fees received by him to L, who was not a Chartered Accountant, under the nomenclature of office allowance and such an arrangement continued for a number of years.* *(4 Marks)*

(d) *M, a practicing Chartered Accountant sent a letter to another firm of Chartered Accountants, claiming himself to be a pioneer in liasoning with Central Government Ministries and its allied Departments for getting vanous Government clearances for which he had claimed to have expertise and had given a list of his existing clients and details of his staff etc.* *(4 Marks)*

Answer

(a) Failure to obtain information: Clause 8 of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that if a Chartered Accountant in practice fails to obtain sufficient information to warrant the expression of an opinion or his exceptions are sufficient material to negate the expression of an opinion, the chartered accountant shall be deemed to be guilty of a professional misconduct.

In the instant case Mr. Z, a practicing Chartered Accountant issued a certificate of circulation of a periodical without going into the most elementary details of how the circulation of a periodical was being maintained i.e, by not looking into the financial records, bank statements or bank pass books, by not examining evidence of actual payment of printers bills and by not caring to ascertain how many copies were sold and paid for.

The chartered accountant should not express his opinion before obtaining the required data and information. As an auditor, Mr. Z ought to have verified the basic records to ensure the correctness of circulation figures.

Thus, in the present case Mr. Z will be held guilty of professional misconduct as per clause 8 of part I of Second Schedule of Chartered Accountants Act, 1949.

Alternative Solution is possible on the basis of clause 7 of Part-I of Second Schedule of The Chartered Accountants Act, 1949.

(b) Failure to Observe the Regulations: As per Clause 1 of Part II of Second Schedule to the Chartered Accountants Act, 1949 a member shall be held guilty of professional misconduct if he contravenes any of the provisions of the Act or the regulations made thereunder or any guidelines issued by the Council.

The chartered accountant, as per Regulations also, is expected to impart proper practical training. There is a specific circular issued which guides on timing for training for articleship.

In the instant case, the articled clerk must have not been attending office on a regular basis and the explanation of the Chartered Accountant cannot be accepted. It is also quite likely that the articled clerk would be availing leave quite often and coming late to the office.

Under the circumstances, the Chartered Accountant is guilty of misconduct for making a misstatement to the institute in regard to the discharge of his professional duties.

Note: Alternative Solution is possible as per Schedule II, Part II, Clause (3), a member is deemed to be guilty of professional misconduct if he includes in any information, statement, return or form to be submitted to the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false. In the instant case, X knew about the college timing of his articled assistant and he had given false information to the institute knowing them to be false and hence he will be deemed to be guilty of professional misconduct.

(c) Sharing of Audit Fees with non-member: As per Clause 2 of Part I of First Schedule to the Chartered Accountants Act, 1949 a member shall be held guilty if a Chartered Accountant in practice pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services to time in or outside India.

In the instant case, Mr. K, a practising Chartered Accountant gave 50% of the audit fees received by him to Mr. L, who was not a Chartered Accountant, under the nomenclature of office allowance and such an arrangement continued for a number of years. In this case, it is not the nomenclature to a transaction that is material but it is the substance of the transaction, which has to be looked into.

The Chartered Accountant had shared his profits and, therefore, Mr. K was guilty of professional misconduct under the clause 2 of Part I of First Schedule.

(d) Soliciting work directly or indirectly: As per Clause 6 of Part I of First Schedule to the Chartered Accountants Act, 1949 a member shall be held guilty if a Chartered Accountant in practice solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

Further, as per Central Council Guidelines for Advertisement for the members in practice, write up of the members should not claim superiority over any other Member(s)/Firm(s) and should also not include the names of the clients.

In the present case, Mr. M, a practicing Chartered Accountant sent the letter to another firm of Chartered Accountants, claiming himself to be a pioneer in liasoning with Central Government Ministries and its allied Departments for getting various Government clearances for which he had claimed to have expertise and had also given a list of his existing clients and details of his staff etc. which seems to be indirect methods to adventure their professional practice with a view to gain publicity and thereby solicit clients or professional work.

Hence, Mr. M was guilty of professional misconduct as per clause 6 of part I of First Schedule of the Chartered Accountants Act, 1949.

Question 3

(a) *As the concurrent auditor of Z Bank Ltd you are requested by its management to draft an internal control policy in respect of loans and advances. What factors do you consider as important while drafting such a policy?* *(10 Marks)*

(b) *T Ltd's previous year ended on 31st March 2012. During that period it made a claim for refund of customs duty which was admitted as due by the customs authorities during April 2012. T Ltd neither credited the claim in the profit and loss account nor reported the same in clause 13(b) of Form 3CD for the reason that this has been admitted as due by the authorities only in the next financial year. Further T Ltd had changed the method of determination of cost formula for the purpose of stock valuation from FIFO basis to Weighted Average Cost basis, but that was also not reflected in clause l1(b) of Form 3CD which requires reporting on change in accounting method employed. Comment. (6 Marks)*

Answer

(a) Factors to be considered for drafting of Internal control policy for Loans and Advances:

The following are the important factors to be considered while drafting internal control policy in respect of loans and advances of a Z bank Ltd.:

1. The bank should make advances only after satisfying itself as to the creditworthiness of the borrowers and after obtaining sanction from the proper authorities of the bank.
2. All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
3. Sufficient margin should be kept against securities taken so as to cover any decline in the value thereof and also to comply with Reserve Bank directives. Such margins

should be determined by the proper authorities of the bank as a general policy or for particular accounts.

4. All the securities should be received and returned by responsible officer. They should be kept in the Joint custody of two such officers.
5. All securities requiring registration should be registered in the name of the bank or otherwise accompanied by the documents sufficient to give title of the bank.
6. In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipts. The godowns should be regularly and frequently inspected by a responsible officer of the branch concerned, in addition by the inspectors of the bank.
7. Surprise checks should be made in respect of hypothecated goods not in the possession of the bank.
8. Market value of goods should be checked by officers of the bank by personal enquiry in addition to the invoice value given by the borrowers.
9. As soon as any increase or decrease takes place in the value of securities proper entries should be made in the Drawing Power Book and Daily Balance Book. These entries should be checked by an officer.
10. All accounts should be kept within both the drawing power and the sanctioned limit at all times.
11. All the accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the Management/Head Office regularly.
12. The operation in each advance should be reviewed at least once every year.
13. Post disbursement supervision and follow-up should be proper, such as receipt of stock statements, instalments, renewal of limits, etc
14. There should not be any misutilisation of the loans and instances indicative of diversion of funds should be checked.
15. Letters of credit issued by the branch should be within the delegated power and should be for genuine trade transactions.
16. Bank guarantees issued, should be properly worded and recorded in the register of the bank. They should be promptly renewed on the due dates.
17. Proper follow-up should be made for overdue bills of exchange.
18. The classification of advances should be done as per RBI guidelines.
19. The submission of claims to DICGC and ECGC should be on time.

20. Instances of exceeding delegated powers should be promptly reported to controlling/Head Office by the branch and should be got confirmed or ratified at the required level.

(b) **Reporting requirement under Form 3CD** : As per Clause 13(b) of Form 3CD, the details of the Refund of custom duty, if admitted as due by the concerned authorities but not credited to the profit and loss account, are to be stated. But the Credits/Claims which have been admitted as due after the relevant previous year need not be reported in Form 3 CD.

In the instant case, the action of T Ltd in not crediting the claim to the profit and loss account and also not reporting of the same in Clause 13(b) of Form 3CD is in order.

Further Clause 11(b) requires reporting when there has been any change in the method of accounting employed vis-a-vis the accounting method employed in the immediately preceding year. However, change in an accounting policy will not amount to a change in the method of accounting and hence such change in the accounting policy need not be mentioned under Clause 11(b). It may be noted that change in the method of valuation of stock will amount to a change in accounting policy. However, it should be disclosed in the financial statements.

In the instant case, non-reporting of the change in the method of determination of cost formula of valuation of stock from FIFO to Weighted average Cost basis, in clause 11(b) of Form 3CD is in order.

Hence in the above situation, there is no reporting requirement under Clause 13(b) and Clause 11(b).

Question 4

(a) *In the course of audit of Q Ltd, its statutory auditor wants to be sure of the adequacy of related party disclosures? Kindly guide the auditor in identifying the possible source of related party information.* *(8 Marks)*

(b) *Z Ltd is intending to acquire A Ltd. It hires B & Co., a firm of Chartered Accountants to conduct a due diligence. B & Co., wants to reduce the risk of over valuation of assets in its due diligence exercise. Kindly guide B & Co.* *(8 Marks)*

Answer

(a) **Identification of Related Parties:** As per SA 550 on, "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties. However, it is the management, which is primarily responsible for identification of related parties. The duties of an auditor with regard to reporting of related party transaction as required by Accounting Standard 18 is given in SA550.

1. SA 550 requires that to identify names of all known related parties, the auditor may inspect records or documents that may provide information about related party

relationships and transactions, for example entity income tax returns, information supplied by the entity to regulatory authorities, shareholder registers to identify the entity's principal shareholders, statements of conflicts of interest from management and those charged with governance, records of the entity's investments and those of its pension plans, contracts and agreements with key management or those charged with governance, significant contracts and agreements not in the entity's ordinary course of business, specific invoices and correspondence from the entity's professional advisors, life insurance policies acquired by the entity, significant contracts re-negotiated by the entity during the period, internal auditors' reports, documents associated with the entity's filings with a securities regulator (e.g, prospectuses).

2. Some arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions as an arrangement involves a formal or informal agreement between the entity and one or more other parties for such purposes as the establishment of a business relationship through appropriate vehicles or structures, the conduct of certain types of transactions under specific terms and conditions or the provision of designated services or financial support.

   Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor include participation in unincorporated partnerships with other parties, agreements for the provision of services to certain parties under terms and conditions that are outside the entity's normal course of business, guarantees and guarantor relationships etc.

3. Obtaining further information on significant transactions outside the entity's normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and, where the applicable financial reporting framework establishes related party requirements, to identify the risks of material misstatement. In addition, the auditor needs to be alert for transactions which appear unusual in the circumstances and which may indicate the existence of previously unidentified related parties. Examples of transactions outside the entity's normal course of business may include complex equity transactions, such as corporate restructurings or acquisitions, transactions with offshore entities in jurisdictions with weak corporate laws, the leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged, sales transactions with unusually large discounts or returns, transactions with circular arrangements, for example, sales with a commitment to repurchase, transactions under contracts whose terms are changed before expiry etc.

4. Finally, the auditor should also obtain a written representation from the management concerning the completeness of information provided regarding the identification of related parties.

(b) Due Diligence Exercise in case of Overvalued Assets: Due diligence is an all pervasive exercise to review all important aspects like financial, legal, commercial, etc. before taking any final decision in the matter. As far as any overvalued assets are concerned, this shall form part of such a review. Normally, overvalued assets are not apparent from books of accounts and financial statements. Review of financial statements does involve examination from the view point of extraordinary items, analysis of significant deviations, etc. However, in order to reduce the risk of over valuation of assets, the auditor should pay his attention to the following areas:

Overvalued assets: The auditor shall have to specifically examine the following areas:

1. Uncollected/uncollectable receivables
2. Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with the name of company.
3. Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.
4. Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue
5. Litigated assets and property
6. Investments carried at cost though realizable value is much lower
7. Investments carrying a very low rate of income / return
8. Infructuous project expenditure/deferred revenue expenditure etc.
9. Group Company balances under reconciliation etc.
10. Intangibles of no value

Question 5

(a) *A, a practicing Chartered Accountant is appointed to conduct the peer review of another practicing unit. What areas A should review in the assessment of independence of the practicing unit?* *(4 Marks)*

(b) *State the key differences between financial and operational audit.* *(4 Marks)*

(c) *"Non-compliance of Section 58 AA inserted by the Companies (Amendment) Act, 2000 would occur where the company fails to intimate the Company Law Board, any default in repayment of deposits made by small depositors or part thereof or any interest there on."*

Discuss this statement and state reporting requirements under the Companies (Auditor's Report) Order, 2003 for non-compliance of Section 58 AA of the Companies Act, 1956.

(8 Marks)

Answer

(a) Review in the Assessment of Independence of the Practicing Unit – The reviewer should carry out the compliance review of the five general controls, i.e., independence, maintenance of professional skills and standards, outside consultation, staff supervision and development and office administration and evaluate the degree of reliance to be placed upon them. The degree of reliance will, ultimately, affect the attestation service engagements to be reviewed.

A, a practicing Chartered Accountant should review following controls in respect of assessment of independence of the practicing unit:

1. Does the practice unit have a policy to ensure independence, objectivity and integrity, on the part of partners and staff? Who is responsible for this policy?
2. Does the practice unit communicate these policies and the expected standards of professional behaviour to all staff?
3. Does the practice unit monitor compliance with policies and procedures relating to independence?
4. Does the practice unit periodically review the practice unit's association with clients to ensure objectivity and independence?

(b) Differences between Financial and Operational Auditing - The major differences between financial and operational auditing can be described as follows:

(i) Purpose - The financial auditing is basically concerned with the opinion that whether the historical information recorded is correct or not, whereas the operational auditing emphasizes on effectiveness and efficiency of operations for future performance.

(ii) Area - Financial audits are restricted to the matters directly affecting the appropriateness of the presented financial statements but the operational auditing covers all the activities that are related to efficiency and effectiveness of operations directed towards accomplishment of objectives of organization.

(iii) Reporting -The financial audit report is sent to all stock holders, bankers and other persons having stake in the Organisation. However the operational audit report is primarily for the management.

(iv) End Task - The financial audit has reporting the findings to the persons getting the report as its end objective, however, the operational auditing is not limited to reporting only but includes suggestions for improvement also

The main objective of operational auditing is to verify the fulfillment of plans, and sound business requirements. Operational auditing is considered as specialized management information tool. Operational auditing is essentially a function of internal auditing staff. Operational auditing is a systematic process of evaluating an organisation's effectiveness, efficiency and economy of operations under management control and reporting to appropriate persons, the result of the evaluation along with recommendations for improvements. Operational audit concentrates on effectiveness, efficiency and economy of operations and therefore it is future oriented. It does not end with the reporting of the findings but also recommends the steps for improvements in future. Operational auditing is not different from internal auditing; it is merely an extension of internal auditing into operational areas.

While in financial auditing, the concentration is more in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are minimized or removed. In financial auditing, an auditor is called upon to review the financial statements of an enterprise to ascertain whether they reflect true and fair view of its state of affairs and of its working results. He may analyse the operations of an enterprise to appraise their cost effectiveness and also he may seek evidence to review the managerial performances.

(c) Reporting Requirements: Under paragraph 4(vi) of Companies (Auditor's) Report Order 2003, the audit report should include following matters:

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

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

3. Non-compliance of Section 58AA occurs where company fails to intimate company law board, any default in repayment of deposit by small depositors or part thereof or any interest thereupon. The auditor has, therefore, to first determine whether there is any default in repayment of such deposits, when number of depositors are large, it may not be possible for an auditor to verify each repayment. In such situation, he should examine internal control systems.

4. He should obtain schedule of repayment to small depositors, and should make reasonable test checks of repayments made by the company. If during test check, default in repayment is noticed, he should see whether the same has been intimated to Company Law Board

5. Over and above this, auditor should also examine regarding non-compliance of Section 58AA or rules made there under he should enquire about any order passed by any of the relevant authorities for contravention of Section 58AA

6. The auditor should obtain management representation to the effect whether:

(i) The company has complied with directives issued by RBI and provision of Section 58AA or relevant rules and

(ii) Where an order has been passed by any of the relevant authorities, the company has complied with the requirements of the order

Question 6

(a) *In the audit of K Ltd, its auditor wants to use CAATs for performing various audit procedures. Guide him as to what procedures can be performed using CAATs.* *(6 Marks)*

(b) *State the "Mandatory Review" areas of the audit committee.* *(4 Marks)*

(c) *In the course of audit of A Ltd you suspect the management has indulged in fraudulent financial reporting? State the possible source of such fraudulent financial reporting.*

(6 Marks)

Answer

(a) **Auditing procedures using CAATs:** CAATs may be used in performing various auditing procedures, including the following:

1. Tests of details of transactions and balances, for example, the use of audit software for recalculating interest or the extraction of invoices over a certain value from computer records;
2. Analytical procedures, for example, identifying inconsistencies or significant fluctuations;
3. Tests of general controls, for example, testing the set-up or configuration of the operating system or access procedures to the program libraries or by using code comparison software to check that the version of the program in use is the version approved by management ;
4. Sampling programs to extract data for audit testing;
5. Tests of application controls, for example, testing the functioning of a programmed control; and
6. Re-performing calculations performed by the entity's accounting systems.

(b) **Mandatory Review Areas of the Audit Committee:** The Audit Committee shall mandatorily review the following information as per Clause 49 of the Listing Agreement:

1. Management discussion and analysis of financial condition and results of operations;
2. Statement of significant related party transactions (as defined by the audit committee), submitted by management;

3. Management letters / letters of internal control weaknesses issued by the statutory auditors;

4. Internal audit reports relating to internal control weaknesses; and

5. The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.

(c) Possible Sources of Fraudulent Financial Reporting: As per SA 240, "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements", fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. It may be accomplished by manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared or Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information or intentional misstatements involve intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure etc.

It often involves management override of controls, misappropriation of assets etc that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

1. Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.

2. Inappropriately adjusting assumptions and changing judgments used to estimate account balances.

3. Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.

4. Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.

5. Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.

6. Altering records and terms related to significant and unusual transactions.

7. Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).

8. Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).

9. Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
10. Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Question 7

*Write short notes on any **four** of the following:*

(a) *Mark to Market Margin* *(4 Marks)*

(b) *Cost Statements* *(4 Marks)*

(c) *Matter to be reported in respect of inventory in the case of a special audit of a non-corporate borrower of a Bank.* *(4 Marks)*

(d) *Solvency Margin* *(4 Marks)*

(e) *Statistical and Non-Statistical Sampling* *(4 Marks)*

Answer

(a) Mark to Market Margin (MTM) : MTM margin is the notional loss, which a stock member or his client would incur, if the net cumulative outstanding positions in all securities were closed out at the closing price of the relevant trading day, which is different from the price at which the transaction had been entered into. For each security, this is worked out by multiplying the difference between the closing price and the price at which the trade was executed by the cumulative buy and sell open position (for buy position the close price being lower than actual trade price and for sell position the close price being higher than actual trade price). The aggregate amount computed across all securities is MTM margin payable by a member. The mark-to-market margin is payable with reference to net position at client's level.

(b) Cost Statements - Cost Statements or cost sheets are required to be prepared as part of the cost records in respect of each product. The forms of cost sheets have been prescribed in the Annexure to the respective Rules. The forms have been so devised arranged that they progressively build up the cost of production of the concerned products. The nature, purpose and contents of the cost sheet depend upon the nature of the products, production method, process involved, cost centres and the elements that make up the cost.

(c) Matter to be reported in respect of inventory in the case of a special audit of a non-corporate borrower of a Bank : A lending bank may, in special cases, require the non-corporate entity to obtain a special report from the auditor. Such a report can be called by a lending bank if it finds that it is necessary to have more information about the working of the entity. In such a case the report will have to be given by the auditor on a quarterly basis. The special audit report which is to be given on a quarterly basis in the specified form is in addition to the normal audit report which is to be given by the auditor on a yearly basis.

1. In the quarterly special audit report, the auditor will have to give information relating to the operating data for each quarter. This information will have to be classified in the actual production; actual production as a percentage of rated capacity, sales, cost of goods sold/cost of production etc. Further, the age-wise classification of raw materials and finished goods is to be given.

2. For this purpose, age-wise classification is to be made in the following manner in respect of raw materials and finished goods separately:

   a. Inventory for more than 1 year

   b. Between 6 months and 1 year

   c. Between 3 months and 6 months

   d. Below 3 months

      1. Similar information about the work-in-progress (i.e the number of days of production which remains in progress) should also be given.

      2. The basis of the valuation of raw material and finished goods should be given. For this purpose, the following information is to be given:

         i) The manner of determination of cost (i.e components of cost)

         ii) The method of valuing stock i.e FIFO, weighted average cost.

(d) Solvency Margin : Section 64VA of the Insurance Act, 1938, inter alia, requires every insurer to maintain an excess of the value of its assets over the amount of its liabilities at all times. The excess is known as 'Solvency Margin'. In the case of an insurer carrying on general insurance business, the solvency margin should be the highest of the following amounts:

(a) fifty crore rupees (one hundred crores of rupees in case of a reinsurer); or

(b) a sum equivalent to twenty percent of net premium income; or

(c) a sum equivalent to thirty percent of net incurred claims,

subject to credit for reinsurance in computing net premiums and net incurred claims being actual but a percentage, determined by the regulation but not exceeding fifty percent. It may be noted that conditions regarding maintenance of the above mentioned solvency margin may be relaxed by the Authority in certain special circumstances.

If, at any time, an insurer does not maintain the required solvency margin, the insurer is required to submit a financial plan to the Authority indicating the plan of action to correct the deficiency in the solvency margin. If, on consideration of the plan, the Authority finds it inadequate, the insurer has to modify the financial plan.

Maintenance of solvency margin has a great importance for an insurance company considering their size and nature of business and also involvement of public money. Sub-section (2C) of Section 64A states that if an insurer fails to comply with the requirements of the Insurance Act, 1938, it shall deemed to be insolvent and may be wound up by the Court.

(e) Statistical and Non-statistical Sampling:

Audit sampling means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population

As per SA 530, "Audit Sampling", the auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

There are two major methods in which the size of the sample and the selection of individual items of the sample are determined. These methods are statistical and non-statistical sampling.

1. Statistical sampling: This is a method of audit testing which is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, debtors' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

2. Non-statistical sampling: Under this method, the sample size and its composition are determined on the basis of the personal experience and knowledge of the auditor. This method has been in common application for many years because of its simplicity in operation. Traditionally, the auditor on the basis of his personal experience will determine the size of the sample and express it in terms that number of pages or personal accounts in the purchases or sales ledger to be checked. For example, March, June & September may be selected in year one and different months would be selected in the next year. An attempt would be made to avoid establishing a pattern of selection year after year to maintain an element of surprise as to what the auditor is going to check. It is a common practice to check large number of items towards the close of the year so that the adequacy of cut-off procedures can also be determined.