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PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

Question No. 1 is compulsory

Answer any five from the rest

Question 1

1. (a) ABC Company files a law suit against Unlucky Company for ₹ 5 crores. The Attorney of Unlucky Company feels that the suit is without merit, so Unlucky Company merely discloses the existence of the law suit in the notes accompanying its financial statements. As an auditor of Unlucky Company, how will you deal with the situation? (5 Marks)
- (b) T & Co. wants to issue a prospectus, to provide potential investors with information about future expectations of the Company. You are hired by T & Co. to examine the projected financial statements and give report thereon. What things you will consider before accepting the audit engagement and what audit evidence will be obtained for reporting on projected financial statements? (5 Marks)
- (c) In the course of audit of K Ltd., its auditor Mr. 'N' observed that there was a special audit conducted at the instance of the management on a possible suspicion of a fraud and requested for a copy of the report to enable him to report on the fraud aspects. Despite many reminders it was not provided. In absence of the special audit report, Mr. 'N' insisted that he be provided with at least a written representation in respect of fraud on/by the company. For this request also, the management remained silent. Please guide Mr. 'N'. (5 Marks)
- (d) During the course of audit of Star Limited the auditor received some of the confirmation of the balances of creditors outstanding in the balance sheet through external confirmation by negative confirmation request. In the list of Sundry Creditors there are number of creditors of small balances except one, old outstanding of ₹ 15 Lacs, of whom, no confirmation on the credit balance received. Comment with respect to Standard of Auditing. (5 Marks)

Answer

- (a) As per AS 29 "Provisions, Contingent liabilities and Contingent Assets", a contingent liability is a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise;

Further, future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that the event will occur.

As per SA 570 "Going Concern", there are certain examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. Pending legal or regulatory proceedings against the entity that may, if

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successful, result in claims that the entity is unlikely to be able to satisfy is one of the example of such event.

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 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 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 realize its assets and discharge its liabilities in the normal course of business.

In the instant case, ABC Company has filed a law suit against Unlucky Company for ₹ 5 crores. Though, the attorney of Unlucky Company feels that the suit is without merit so the company merely discloses the existence of law suit in the notes accompanying its financial statements. But the auditor may evaluate the source data on which basis the opinion is formed. If the auditor finds the uncertainty, he may request the management to adjust the sum of ₹ 5 crore by making provision for expenses as per AS 29. If the management does not accept the request the auditor should qualify the audit report.

(b) **Projected Financial Statements:** As per SAE 3400, "The Examination of Prospective Financial Information", the answer is divided into two parts i.e. (i) the things to be considered before accepting the engagement and (ii) audit evidence to be obtained for reporting on projected financial statements.

(i) **Acceptance of Engagement:** As per SAE 3400, "The Examination of Prospective Financial Information", before accepting an engagement to examine prospective financial information, the auditor would consider, amongst other things

- (1) the intended use of the information;
- (2) whether the information will be for general or limited distribution;
- (3) the nature of the assumptions, that is, whether they are best-estimates or hypothetical assumptions;
- (4) the elements to be included in the information; and
- (5) the period covered by the information.

Further, the auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

In accordance with SA 210, "Terms of Audit Engagement", it is necessary that the auditor and the client should agree on the terms of the engagement.

(ii) **Audit evidence to be obtained for Reporting on Projected Financial Statements:** The auditor should document matters, which are important in providing

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evidence to support his report on examination of prospective financial information, and evidence that such examination was carried out.

The audit evidence in form of working papers will include:

- (1) the sources of information,
- (2) basis of forecasts and
- (3) the assumptions made in arriving the forecasts,
- (4) hypothetical assumptions, evidence supporting the assumptions,
- (5) management representations regarding the intended use and distribution of the information, completeness of material assumptions,
- (6) management's acceptance of its responsibility for the information,
- (7) audit plan,
- (8) the nature, timing and extent of examination procedures performed, and,
- (9) in case the auditor expresses a modified opinion or withdraws from the engagement, the reasons forming the basis of such decision.

- (c) **Auditors Responsibilities Relating to Fraud:** As per SA 240, "The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements", the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. In addition an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor.

As per SA 580, "Written Representations", if management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist. Further, If management does not provide one or more of the requested written representations, the auditor shall discuss the matter with management; re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

The auditor shall disclaim an opinion on the financial statements if the auditor concludes that there is sufficient doubt about the integrity of management such that the written representations are not reliable; or management does not provide the written representations.

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Further the auditor is required to report as per Paragraph 4 (xxi) of CARO, 2003, if there is any fraud on or by the company has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

In the instant case, in the course of audit of K Ltd., its auditor Mr. N observed that there was a special audit conducted at the instance of the management on a possible suspicion of fraud. Therefore, the auditor requested for special audit report, which was not provided by the management despite of many reminders. Mr. N also insisted for written representation in respect of fraud on/by the company. For this request also management remained silent.

Hence, the fact is required to be reported as per Paragraph 4(xxi) of the CARO, 2003 and the auditor should also disclaim an opinion on the financial statements.

- (d) **External Confirmation:** As per SA 505, "External Confirmation", Negative Confirmation is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative confirmations provide less persuasive audit evidence than positive confirmations.

The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request. Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favor, and less likely to respond otherwise.

In the instant case, the auditor sent the negative confirmation requesting the creditors having outstanding balances in the balance sheet while doing audit of Star Limited. One of the old outstanding of rupees 15 lacs has not sent the confirmation on the credit balance. In case of non response, the auditor may examine subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes. Further non response for negative confirmation request does not mean that there is some misstatement as negative confirmation request itself is to respond to the auditor only if the confirming party disagrees with the information provided in the request.

But, if the auditor identifies factors that give rise to doubts about the reliability of the response to the confirmation request, he shall obtain further audit evidence to resolve those doubts.

#### Question 2

*Give your comments with reference to Chartered Accountants Act, 1949 and Schedules there to.*

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- (a) Mr. 'E', a practicing Chartered Accountant, was requested by one of his client to prepare a projection for next five years and also a report on the same. Mr. 'E' after having prepared the same stated in his report 'The sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts. He also stated that he does not vouch for the accuracy of the forecasts. (4 Marks)
- (b) Mr. 'A' is a practicing Chartered Accountant working as proprietor of M/s A & Co. He went abroad for 3 months. He delegated the authority to Mr. 'Y' a Chartered Accountant his employee for taking care of routine matters of his office. During his absence Mr. 'Y' has conducted the under mentioned jobs in the name of M/s A & Co.
- (i) He issued the audit queries to client which were raised during the course of audit.
- (ii) He issued production certificate to a client under Central Excise Act, 1944.
- (iii) He attended the Income Tax proceedings for a client as authorized representative before Income Tax Authorities.
- Please comment on eligibility of Mr. 'Y' for conducting such jobs in name of M/s A & Co. and liability of Mr. 'A' under the Chartered Accountants Act, 1949. (5 Marks)
- (c) Mr. 'G', while applying for a certificate of practice, did not fill in the columns which solicit information about his engagement in other occupation or business, while he was indeed engaged in a business. (3 Marks)
- (d) Mr. 'C', a Chartered Accountant holds a certificate of practice while in employment also, recommends a particular lawyer to his employer in respect of a case. The lawyer, out of the professional fee received from employer paid a particular sum as referral fee to Mr. 'C'. (4 Marks)

**Answer**

- (a) **Certification of Financial Forecast:** As per Clause (3) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice is deemed to be guilty of professional misconduct if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast.

Accuracy does not refer to arithmetical accuracy. All forecasts are estimates based on certain assumptions duly evaluated on a consideration of various relevant factors and cannot be ascertained with accuracy. The Guidance Note on Accountants Report on Profit Forecasts and/or Financial forecast considered the implications of this clause and made it clear that the chartered accountant can participate in the preparation of profit or financial forecasts and review them. But, first of all, he should clearly indicate in his report the sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts and, secondly, he should not vouch for the accuracy of the forecasts.

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In the instant case, Mr. E after having prepared the projections for next five years stated in his report, "the sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts." He also stated that he does not vouch for the accuracy of the forecasts. Therefore there is no violation of the Chartered Accountants Act, 1949 and its Regulations.

- (b) **Delegation of Authority to the Employee:** As per clause 12 of Part I of the First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct "if he allows a person not being a member of the Institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements".

In this case CA 'A' proprietor of M/s A & Co., went to abroad and delegated the authority to another Chartered Accountant Mr. Y, his employee, for taking care of routine matters of his office who is not a partner but a member of the Institute of Chartered Accountants

The Council has clarified that the power to sign routine documents on which a professional opinion or authentication is not required to be expressed may be delegated in the following instances and such delegation will not attract provisions of this clause like issue of audit queries during the course of audit, asking for information or issue of questionnaire, attending to routing matters in tax practice, subject to provisions of Section 288 of Income Tax Act etc.

- (i) In the given case, Mr. 'Y', a chartered accountant being employee of M/s A & Co has issued audit queries which were raised during the course of audit. Here "Y" is right in issuing the query, since the same falls under routine work which can be delegated by the auditor. Therefore, there is no misconduct in this case as per clause 12 of Part 1 of First schedule to the Act.
- (ii) Further, issuance of production certificate to a client under Central Excise Act, 1944 by Mr. "Y" being an employee of M/s A & Co. (an audit firm), is not a routine work and it is outside his authorities. Thus, CA 'A' is guilty of professional misconduct under clause 12 of Part I of First Schedule of the Chartered Accountants Act, 1949.
- (iii) In this instance, Mr. "Y", CA employee of the audit firm M/s A & Co. has attended the Income tax proceedings for a client as authorized representative before Income Tax Authorities. Since the council has allowed the delegation of such work, the chartered accountant employee can attend to routine matter in tax practice as decided by the council, subject to provisions of Section 288 of the Income Tax Act. Therefore, there is no misconduct in this case as per clause 12 of Part 1 of First schedule to the Act.
- (c) **Disclosure of Information:** As per Clause 2 of Part III of First Schedule to the Chartered Accountants Act, 1949 a member shall be held guilty if a Chartered Accountant, in practice or not, does not supply the information called for, or does not comply with the

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requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority;

In the given case, Mr. "G", a Chartered Accountant while applying for a certificate of practice, did not fill in the columns which solicit information about his engagement in other occupation or business, while he was indeed engaged in a business. Details of engagement in business need to be disclosed while applying for the certificate of practice as it was the information called for in the application, by the Institute.

Thus, Mr. G will be held guilty for professional misconduct under the clause 2 of Part III of First Schedule of the Chartered Accountants Act, 1949.

- (d) **Referral Fee from Lawyer:** According to Clause 2 of Part II of First Schedule of the Chartered Accountant Act, 1949, a member of the Institute (other than a member in practice) shall be guilty of professional misconduct, if he being an employee of any company, firm or person accepts or agrees to accept any part of fee, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

In the present case, Mr. C who beside holding a certificate of practice, is also an employee and by referring a lawyer to the company in respect of a case, he receives a particular sum as referral fee from the lawyer out of his professional fee.

Therefore, Mr. C is guilty of professional misconduct by virtue of clause 2 of Part II of First schedule

### Question 3

- (a) *A Ltd. is a Chennai based company. The total turnover of the company is ₹ 10 crores for the year 2012-13. The company has a branch office at an area which was recently affected by flood. The transportation services are not available due to destruction caused by flood. The branch office recorded turnover of ₹ 1,50,000 in the Financial Year 2012-13. No audit of branch has been carried out. The statutory auditor of the company has made no reference of the above branch in his report. Comment. (4 Marks)*
- (b) *Mr. 'U', a respectable Chartered Accountant of international repute was requested by one of the major corporates in India to join its Board and also as a Chairman of Audit Committee. He expressed his apprehensions that he is not having the requisite experience. Mr. 'U' seeks your view on the responsibility of Audit Committee vis-a-vis the review of Financial Statements. (4 Marks)*
- (c) *For the year ended on 31<sup>st</sup> March, 2014, P Ltd. proposed to pay a dividend of 25% on its equity shares and it further proposed to transfer 20% of Net profit for that year after tax to its reserves. Its auditor objected to the same stating that 10% is the maximum permissible limit to transfer to reserves. Comment. (4 Marks)*

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- (d) *In assessment procedure of M/s Cloud Ltd., Income Tax Officer observed some irregularities. Therefore he started investigation of Books of Accounts audited and signed by Mr. Old, a practicing Chartered Accountant. While going through books he found that M/s Cloud Ltd. used to maintain two sets of Books of Accounts, one is the official set and other is covering all the transactions. Income Tax Department filed a complaint with the Institute of Chartered Accountants of India saying Mr. Old had negligently performed his duties. Comment.* (4 Marks)

**Answer**

- (a) **Branch Audit:** Section 228 of the Companies Act, 1956 requires that the accounts of a branch office of a company are required to be audited either by the company's auditor or by any other person qualified for appointment as auditor of the company. So, normally speaking, the audit of branch office has to be carried out unless the company has obtained exemption under the Companies (Branch Audit Exemptions) Rules, 1961 formulated u/s 228(4), having regard to quantum of activity or subject to fulfillment of certain conditions like, If for any suitable reason, the Central Government is satisfied that exemption may be granted from the purview of compulsory audit of branch accounts. As per quantum of activity, the rule provides for the exemption of a branch office of a company from audit if the average quantum of activity of the branch does not exceeds ₹ 2 lakhs or 2% of the average turnover of the company.

In the given situation, A Ltd. is a Chennai based company, having total turnover of ₹ 10 Crore. The company is having a branch office at an area which is recently affected by flood. In the absence of other factors, assuming the given turnover as average one as per section 228, the turnover of the branch is less than ₹ 2.00 lakhs or 2% of the average turnover, hence the branch will be exempt from purview of audit.

Further, the auditor is also required to mention this fact in the audit report as per section 227(3) and deal appropriately.

Therefore, no reference of above branch in statutory auditors report is not correct.

- (b) **Responsibility of Audit Committee vis a vis review of Financial Statements:** The responsibility of the audit committee while reviewing the annual financial statements with management before submission to the Board, focuses primarily on:
- (i) Any changes in accounting policies / and practices;
  - (ii) Major accounting entries based on exercise of judgments by management;
  - (iii) Qualification in draft audit report;
  - (iv) Significant adjustments arising out of audit;
  - (v) The going concern assumption;
  - (vi) Compliance with accounting standards;

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- (vii) Compliance with stock exchanges and legal requirement concerning financial statements.
- (viii) Any related party transactions.
- (c) **Transfer to Reserve:** As per Section 205(2A) of the Companies Act, 1956, no company is permitted to declare or pay dividend for any financial year out of the profits of that year without first transferring to reserve which is prescribed under the Companies (Transfer of Profits to Reserve) Rules, 1975. The percentage of profits required to be transferred to reserves have been related to the rate of dividend proposed for the year i.e. if rate of dividend declared is more than 20%, than minimum 10% should be transferred to Reserve. The aforesaid requirement of transferring profits to reserve, subject to a ceiling of 10% is not a ban on a higher transfer.

A company can transfer to reserve a percentage, of profits higher than 10%. For doing that it must comply with further conditions laid down in the Companies (Transfer of Profits to Reserves) Rules, 1975. If the company wishes to transfer a higher percentage and is also contemplating declaration of dividend it is to ensure a rate of dividend for the year equal to the average rate of dividend declared in respect of the immediately preceding three years. In a case where bonus shares have also been issued in the financial year in which the dividend is declared, or in the three years immediately preceding the financial year, a minimum distribution sufficient for the maintenance of dividends to shareholders at an amount equal to the average amount (quantum) of dividend declared over the three years immediately preceding the financial years is to be ensured. However, if the net profit after tax for the year is lower at least 20% compared to the average net profit after tax at the immediately two preceding years, the company will not be required to ensure the maintenance of the average amount/rate of dividend mentioned earlier.

In the instant case, if the conditions mentioned above are satisfied the Company may transfer 20% of Net Profit for that year after tax to its reserves.

- (d) **Liability of Auditor:** "It is the auditor's responsibility to audit the statement of accounts and prepare tax returns on the basis of books of accounts produced before him. Also if he is satisfied with the books and documents produced to him, he can give his opinion on the basis of those documents only by exercising requisite skill and care and observing the laid down audit procedure.

In the instant case, Income tax Officer observed some irregularities during the assessment proceeding of M/s Cloud Ltd. Therefore he started investigation of books of accounts audited and signed by Mr. Old, a practicing Chartered Accountant. While going through the books, he found that M/s Cloud Ltd. Used to maintain two sets of Books of Accounts, one is the official set and other is covering all the transactions. Income Tax Department filed a complaint with the ICAI saying Mr. Old had negligently performed his duties.

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Mr. Old, the auditor was not under a duty to prepare books of accounts of assessee and he should, of course, neither suggest nor assist in the preparations of false accounts. He is responsible for the books produced before him for audit. He completed his audit work with official set of books only.

In this situation, as Mr. Old, performed the auditing with due skill and diligence; and, therefore, no question of negligence arises. It is the duty of the Department to himself investigate the truth and correctness of the accounts of the assessee.

**Question 4**

- (a) *H Ltd. granted unsecured loan of ₹ 1 crore @ 15% p.a. to two of its subsidiaries during the Financial Year 2012-13. Before the year end both the companies repaid the loan. The management of H Ltd. is of the opinion that since no balance is outstanding as on 31<sup>st</sup> March 2013, these loans are not required to be reported in CARO 2003. Comment and draft a suitable report. (4 Marks)*
- (b) *In the course of audit of Y Ltd., as the auditor of the company you observe the following:*
- (i) *The company has advanced a loan to a firm in which a director was interested at a rate lower than the prevailing market rate as well as there was no agreement on terms of repayment.*
- (ii) *There are certain transactions which ought to have been entered in the register maintained u/s 301, were omitted to be entered.*
- How auditor will report in CARO 2003? (6 Marks)*
- (c) *X Limited is the holding company of Y Limited and Z Limited. Explain the nature of current period consolidation adjustments which will be taken into account for the preparation of Consolidated Financial Statements. (6 Marks)*

**Answer**

- (a) **Reporting requirement under CARO, 2003:** As per Paragraph 4 (iii) (a) the auditor has to report on if the company has granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 301 of the Act. If the company has done so, then, the clause requires that the auditor's report should disclose the "number of parties" and "amount involved" in such cases. The clause covers not only the loan granted during the year but covers all loans including opening balances. Further, there is no stipulation regarding the loan being given in cash or in kind.

It may so happen that a party listed in the register maintained under section 301 of the Act might take a loan from the company and repays it to the company during the financial year concerned. Therefore, while examining the loans, the auditor should also take into consideration the loan transactions that have been squared-up during the year and report such transactions under the clause. Apart from reporting the number of parties, the auditor is also required to disclose the "amounts involved".

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In the given case, H Ltd. has granted unsecured loan of ₹ 1 crore @15% p.a. to two of its subsidiaries during the Financial Year 2012-13. During the year, both the companies have repaid its loan. Therefore, the auditor need to consider the transaction and report the details regarding such loan given to its subsidiaries and the amount involved.

**Draft Report**

*"The Company has granted loan of ₹ 1 Crore @ 15% p.a. to 2 of its subsidiaries covered in the register maintained under Section 301 of the Companies Act, 1956 during the Financial Year 2012-13. The maximum amount involved during the year was ₹ 1.00 crore and the year-end balance of such loans was Nil".*

**(b) Reporting requirement under CARO, 2003 :**

- (i) As per Paragraph 4 (iii)(b) the auditor has to report whether the rate of interest and other terms and conditions of loans given by the company, secured or unsecured, are prima facie prejudicial to the interest of the company".

In the given case, Y Ltd. has advanced a loan to a firm in which a director was interested at a rate lower than the prevailing market rate and there is no agreement on terms of repayment is prima facie prejudicial to the interest of the company. Hence reporting is required in view of Paragraph 4 (iii) (b) of CARO, 2003.

- (ii) As per Paragraph 4(v) (a) of CARO, 2003 the auditor has to report whether the particulars of contracts or arrangements referred to in section 301 of the Companies Act, 1956, have been entered in the register required to be maintained under that section".

In the instant case, there are certain transactions which ought to have been entered in the register maintained under section 301, were omitted to be entered, therefore it needs reporting as per Paragraph 4 (v) (a) of CARO, 2003.

**(c) Current Period Consolidation Adjustments:** Current period adjustments are those adjustments that are made in the accounting period for which the consolidation of financial statements is done. Current period consolidation adjustments primarily relate to elimination of intra-group transactions and account balances including:

- (i) intra-group interest paid and received, or management fees, etc;
- (ii) unrealised intra-group profits on assets acquired from other subsidiaries;
- (iii) intra-group indebtedness;
- (iv) adjustments related to harmonizing the different accounting policies being followed by the parent enterprise and its subsidiaries;
- (v) adjustments made for the effects of significant transactions or other events that occur between the date of the financial statements of the parent and one or more of the components, if the financial statements to be used for consolidation are not drawn upto the same reporting date; and

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- (vi) determination of movement in equity attributable to the minorities since the date of acquisition of the subsidiary.

**Question 5**

- (a) *Shy & Co. had been allotted the branch audit of a nationalized bank for the year ended 31<sup>st</sup> March, 2014. In the audit planning, the partner of Shy & Co. observed that the allotted branches are predominantly based in rural areas and major portion of the advances were for agricultural purpose. He needs your assistance in incorporating the criteria prescribed for determination of NPA norms in respect of agricultural advance, in audit plan. (5 Marks)*
- (b) *M/s ABC & Co., a CA firm was appointed as the auditor of 'Always Safe General Insurance Ltd.' Advise them how they will verify outstanding premium and agent's balances. (6 Marks)*
- (c) *Good Bank Ltd. intends to advance to a customer, based on the stocks and receivables. It appoints you to conduct a periodical review of status of stocks and receivables of that borrower. Please draft a suitable program of verification. (5 Marks)*

**Answer**

- (a) **NPA Norms in respect of Agricultural Advance:** A loan granted for short duration crops will be treated as Non Performing Asset, if the instalment of principal or interest thereon remains overdue for two crop seasons and, a loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

As per the guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops. The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him.

The above norms should be made applicable to all direct agricultural advances as listed in the Master Circular on Lending to Priority Sectors. In respect of all other agricultural loans, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.

If natural calamities impair the repaying capacity of agricultural borrowers, banks may decide on their own as a relief measure conversion of the short-term production loan into a term loan or re-schedulement of the repayment period; and the sanctioning of fresh short-term loan, subject to guidelines issued by RBI.

- (b) **Verification of Outstanding Premium and Agents Balances:** The following are the audit procedure to be followed for verification of outstanding premium and agents balances in the case of Insurance Company.

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- (i) Scrutinize and review control account debit balances and their nature should be enquired into.
  - (ii) Examine in operative balances and treatment given for old balances with reference to company rules.
  - (iii) Enquire the reasons for returning the old balances.
  - (iv) Verify old debit balances which may require provision or adjustment. Notes of explanation may be obtained from the management in this regard.
  - (v) Check age-wise, sector-wise analysis of outstanding premium.
  - (vi) Verify whether outstanding premiums have since been collected.
  - (vii) Check the availability of adequate bank guarantee or premium deposit for outstanding premium.
- (c) **Program of verifications for status of Stock and Receivables:** As an auditor for conducting the periodical review of stock and receivables, suitable program of verification will include:
- (A) Verification Program for Stock:**
- (i) Observe Physical Inventory- Inspect the premises to ensure the arrangement of inventory is such that an accurate count is possible.
  - (ii) Determine whether scrap, obsolete, damaged goods and sold inventory are adequately identified and segregated.
  - (iii) Examine issues transactions and supporting documentation for a period before the balance sheet date and determine that goods issued before the balance sheet date have been excluded from raw materials inventory.
  - (iv) Test the costing of the detailed priced inventory listings to obtain a moderate to low level of assurance that accuracy is achieved by tracing unit costs of inventory items to and from suppliers' invoices.
  - (v) Inspect the authentication of all the documents related to the insurance coverage of the inventory.
- (B) Verification Program for Receivables:**
- (i) Trace totals to the comparative summary of accounts receivable balances.
  - (ii) Assess the adequacy of allowance for doubtful accounts by reviewing and testing the process used by management to develop their estimate of collectability. Consider the reasonableness of bad debt expense compared with prior years.
  - (iii) Select sales and credit memoranda to obtain a moderate to low level of assurance that cutoff is achieved by reviewing the cutoff at the time of inventory taking and at year-end.

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- (iv) By doing aging analysis of receivables.
- (v) Ensure if any litigations or dispute is going on in respect of receivables.

**Question 6**

- (a) *ABG & Co., a Chartered Accountant firm has been appointed by C & AG for performance audit of a Sugar Industry. What factors should be considered by ABG & Co., while planning a performance audit of Sugar Industry? (6 Marks)*
- (b) *Mr. 'P' have been appointed as operational auditor of M/s Books & Magazine Ltd. and observed a totaling error in invoice of ₹ 1,000. He has not taken care of the same saying that this is out of scope of his work. Comment. (3 Marks)*
- (c) *What will be your approach in investigation under Section 235 and 237 into the affairs of the company registered under Companies Act, 1956? (4 Marks)*
- (d) *What are the areas excluded from the scope of peer reviewer? (3 Marks)*

**Answer**

- (a) **Factors to be considered while planning the Performance Audit:** While planning a performance audit of Sugar Industry, the auditors should take care of certain factors which are listed below :
  - (i) to consider significance and the needs of potential users of the audit report.
  - (ii) to obtain an understanding of the program to be audited.
  - (iii) to consider legal and regulatory requirements.
  - (iv) to consider management controls.
  - (v) to identify criteria needed to evaluate matters subject to audit.
  - (vi) to identify significant findings and recommendations from previous audits that could affect the current audit objectives. Auditors should determine if management has corrected the conditions causing those findings and implemented those recommendations.
  - (vii) to identify potential sources of data that could be used as audit evidence and consider the validity and reliability of these data, including data collected by the audited entity, data generated by the auditors, or data provided by third parties.
  - (viii) to consider whether the work of other auditors and experts may be used to satisfy some of the auditors' objectives.
  - (ix) to provide sufficient staff and other resources to do the audit.
  - (x) to prepare a written audit plan.
- (b) **Scope of Operational Audit:** Operational auditing is a systematic process involving logical, structured and organized series of procedures. It concentrates on effectiveness, efficiency and economy of operations and therefore it is future oriented. It does not end

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with the reporting of the findings but also recommends the steps for improvement in future.

The main objective of operational auditing is to verify the fulfilment of plans and sound business requirements as also to focus on objectives and their achievement objectives; the operational auditor should not only have a proper business sense, he should also be equipped with a thorough knowledge of policies, procedures, systems and controls, he should be intimately familiar with the business, its nature and problems, and prospects and its environment. Above all, his mind should be open and active so as to be able to perceive problems and prospects, and grasp technical matters.

In carrying out his work probably at every step he will have to exercise judgement to evaluate evidence in connection with the situations and issues; he will have to get the assistance of norms and standards in every operating field to be able to objectively judge a situation. The norms and standards should be such as are generally acceptable or developed by the company itself.

To a traditional internal auditor, a loss of ₹ 1,000 caused by a wrong totaling of invoice is important and this is that he looks for. But for an auditor engaged in the review of operations, carrying out of a proper maintenance programme of the machines is of greater importance because considerable production loss due to machine breaks down can thus be prevented. In both the cases, the auditor's objective is to see that the business and its profitability do not suffer from avoidable loss, but, nevertheless, there is a distinct difference in approach. But it should not be assumed, that, since an operational auditor is concerned with the audit of operations and review of operating conditions, he is not concerned with the financial aspects of transaction and controls.

Hence, contention of operational auditor that totaling error in invoice of ₹ 1,000 is out of scope is not correct as operational audit is being carried out to ensure that all the management functions like planning, organizing, staffing, directing and controlling are working effectively and efficiently. Such kind of error is very much in scope because such an existence of error indicates that control system (controlling function) is not sound.

- (c) **Approach in investigation under section 235 and 237 into the affairs of the Companies:** The general approach for investigation under Sections 235 and 237 of the Companies Act, 1956 is conditioned by the legal requirements in these regards. The affairs of the company may include everything such as goodwill, profit and loss, contracts, investments, assets, shareholding in subsidiaries, decision making, etc. Also the specific circumstances mentioned in these sections like fraud, mismanagement, oppression of any shareholder etc. come within the term "affairs of the company."

Investigation under Sections 235 and 237 do not call for any special approach. Approach/Steps for pursuing the investigation are:

- (i) **Clarity of Terms of Reference:** The approach to any investigation is determined on a consideration of the nature of the investigation and the terms of reference.

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However, the inspector should ensure that the terms of reference are clear, unambiguous and in writing. If he has any doubt about any item in the terms, he should obtain clarification in writing. It should also be, seen that the terms of reference are not too general, because that may frustrate the whole objective of the investigation; the scope of the investigation will become unwieldy and ill defined. An investigation order to investigate into the affairs of the company would be an instance at point. Therefore the inspector should ask for reframing of the order specifying the exact matters to be investigated. He should also take into consideration the possible effect of limitations, if any, put in the terms of reference and should keep the Central Government informed in writing about their effect on the investigation.

- (ii) **Scope of Investigation:** The next point for consideration of the inspector would be the determination of the scope of the investigation on the basis of the terms of reference. At this stage, it may be useful for the inspector to go into the history of the company and its affiliates or associates. He should evaluate the terms of reference in sketching the scope of investigation; this will enable him to locate the limitation, if any, in the terms of reference, not clearly mentioned. For a purposeful investigation, he may need to stretch his inquiry into the books and records of allied and associated persons and concerns and may require to arm himself with the powers given under the Companies Act.
- (iii) **Period for investigation:** He should also have regard to the period over which the investigation should stretch. The evaluation of terms of reference and the consequential determination of the scope of investigation are the twin props on which the entire investigation would rest and, therefore, the inspector appointed under Sections 235 or 237 should devote careful attention to these.
- (iv) **Framing of Programme:** The next step is the investigator/inspector should frame his programme for investigation in a systematic manner. He should keep adequate working notes and papers with references and cross references in a proper and methodical way to aid him in the preparation of the report. The actual process of investigation would be essentially an evidence gathering procedure and, at every step, he should have regard to the procedures laid down in these sections regarding production of documents and evidence, examination on oath and seizure of documents. He should also keep his mind open to the revelations he comes across in the process of evidence collection and should assess whether the programme of investigation needs amendment or modification.
- (v) **Using the work of Experts:** He should also consider whether assistance of other experts like engineers, lawyers, etc., is necessary in the interest of a comprehensive and full proof examination of the documents and information.
- (vi) **Legal requirements and investigation Report:** Only after he has completed the steps in the investigation programme and has marshaled all the information that he

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needed should he prepare his report. He, however, can also make interim report. The findings should be completed and exhaustive. Before he makes his final report he should obtain and keep on record the evidences relied upon by him. By the nature of things, such evidence should be as conclusive as possible depending on circumstances of the case. He should make his report in accordance with the provisions of the Companies Act, 1956.

The general approach for investigations under Sections 235 and 237 should, therefore, be formulated having regard to the terms of reference, scope, the period, the programme and procedure of the investigation and the attending legal requirements specified above.

**(d) Areas excluded from scope of Peer Reviewer are:**

- (i) Management Consultancy Engagements;
- (ii) Representation before various Authorities;
- (iii) Engagements to prepare tax returns or advising clients in taxation matters;
- (iv) Engagements for the compilation of financial statements;
- (v) Engagements solely to assist the client in preparing, compiling or collating information other than financial statements;
- (vi) Testifying as an expert witness;
- (vii) Providing expert opinion on points of principle, such as Accounting Standards or the applicability of certain laws, on the basis of facts provided by the client; and
- (viii) Engagement for Due diligence.

**Question 7**

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

- (a) *Classification of frauds by NBFC.*
- (b) *Causes of risk of material misstatement in CIS environment.*
- (c) *Evaluation of inherent risk at the level of Financial Statements.*
- (d) *Objectives of Internal Check System.*
- (e) *Tolerable misstatement* (4 x 4 = 16 Marks)

**Answer**

- (a) Classification of Frauds by NBFC-** In order to have uniformity in reporting, frauds have been classified as under:
- (i) Misappropriation and criminal breach of trust.
  - (ii) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.

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- (iii) Unauthorised credit facilities extended for reward or for illegal gratification.
- (iv) Negligence and cash shortages.
- (v) Cheating and forgery.
- (vi) Irregularities in foreign exchange transactions.
- (vii) Any other type of fraud not coming under the specific heads as above.

Cases of 'negligence and cash shortages' and 'irregularities in foreign exchange transactions' referred to in items (iv) and (v) above are to be reported as fraud if the intention to cheat/ defraud is suspected/ proved. However, the following cases where fraudulent intention is not suspected/ proved, at the time of detection, will be treated as fraud and reported accordingly:

- (i) cases of cash shortages more than ₹ 10,000/- and
- (ii) cases of cash shortages more than ₹ 5000/- if detected by management/ auditor/ inspecting officer and not reported on the occurrence by the persons handling cash.

NBFCs having overseas branches/offices should report all frauds perpetrated at such branches/offices also to the Reserve Bank as per the prescribed format and procedures.

**(b) Causes of Risk of Material Misstatement in CIS Environment -**

In a CIS environment the risk of a Material financial statement assertions being erroneously stated could arise from the deficiencies in the following cases:

- (i) Program Development and maintenance.
- (ii) System software support.
- (iii) Operations including processing of data.
- (iv) Physical CIS security.
- (v) Control over access to specialized utility program.

**(c) Evaluation of Inherent Risk at the level of Financial Statements -** To assess inherent risk, the auditor would use professional judgment to evaluate numerous factors, having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment.

The following factors will be considered for determination of audit risk at financial statement level.

- (i) Integrity of Management.
- (ii) Management experience, knowledge and changes during the period.
- (iii) Unusual pressures on the Management.

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- (iv) Nature of entity's business.
- (v) Factors affecting the Industry in which the entity operates.
- (d) **Objectives of the Internal Check System** - Following are the objectives of the internal check system:
  - (i) To detect error and frauds with ease.
  - (ii) To avoid and minimize the possibility of commission of errors and fraud by any staff.
  - (iii) To increase the efficiency of the staff working within the organization.
  - (iv) To locate the responsibility area or the stages where actual fraud and error occurs.
  - (v) To protect the integrity of the business by ensuring that accounts are always subject to proper scrutiny and check.
  - (vi) To prevent and avoid the misappropriation or embezzlement of cash and falsification of accounts.
- (e) **Tolerable misstatement** - As per SA 530, "Audit Sampling", a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

Further, while designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality, to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.

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