

PAPER – 3 : ADVANCED AUDITING & PROFESSIONAL ETHICS

Answer Question Nos. 1 and 2 and four from the rest.

Question 1

Comment on the following:

- (a) X Ltd., paid Rs.25 lakhs as advance to Y Ltd. towards the purchase of a printing machinery on 15.1.08 with delivery instructions to deliver the same in the last week of June, 08. Further on 2.2.08 X Ltd. purchased two diesel generator sets from Y Ltd. for Rs.30 lakhs on 90 days Credit term. In the accounts for 2007-08, X Ltd. intends to adjust the advance paid against Credit purchase and show the net amount of Rs.5 lakhs as due from them. As the statutory auditor, how would you deal with this? (5 Marks)
- (b) The Statutory auditors of Getwell Ltd. included certain comments in his report u/s 227 of the Companies Act, 1956. Since the company requested the auditors to drop the above comments, as otherwise it will affect their future business, as a compromise the auditor included the comment in the report in ordinary type. (5 Marks)
- (c) You are the auditor of Easy Communications Ltd. for the year 2007–08. The inventory as at the end of the year i.e. 31.3.08 was Rs.2.25 crores. Due to unavoideable circumstances, you could not be present at the time of annual physical verification. Under the above circumstances how would you ensure that the physical verification conducted by the management was in order? (5 Marks)
- (d) You have been appointed as the auditor of Good Health Ltd. for 2007-08 which was audited by CA Trustworthy in 2006-07. As the Auditor of the company state the steps you would take to ensure that the Closing Balances of 2006-07 have been brought to account in 2007-08 as Opening Balances and the Opening Balances do not contain misstatements. (5 Marks)

Answer

- (a) Since X Ltd. has paid advance amount to the supplier of machinery to be used in the project, such advance amount should be grouped under the head 'Capital Work in Progress'. This is as per requirement of Schedule VI to the Companies Act, 1956 and the existing accounting practice.

If the advance is for purchase of other machinery, it should be grouped under a separate head – say 'Advance Payment for Capital Expenditure' and should be disclosed as next item to Fixed Assets in the Balance Sheet.

In view of the above, the proposal of X Ltd., to show the net balance in the personal account of Y Ltd., is not correct. Such proposal will cancel the two material items in the

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Hence, the auditor should advise X Ltd., to show these two items separately. If X Ltd., does not accept the advice, the auditor should qualify his report with suitable quantification of amount involved.

- (b) As per Section 227(3) (e) of the Companies Act, 1956, one of the issues relating to audit report is that the report shall indicate in Bold or in Italics the observations as comments of the auditor which have any adverse effect on the functioning of the company. According to the Guidance Note issued clause (e) of the sub-section creates a requirement for the auditor to consider any matter leading to the modification of the auditor report on financial statements is likely to have an adverse effect on the functioning of the company and if so the auditors is required to highlight such matter in Bold or in Italics.

In the instant case, the auditor's action in having printed certain comments in ordinary type is contrary to the provision of the Act and Guidance Note. He will be deemed to have discharged his duties negligently.

- (c) The auditor should perform audit procedures, designed to obtain sufficient appropriate audit evidence during his attendance at physical inventory counting (AAS 34). AAS 34 is additional guidance to that contained in AAS 5.

If the auditor is unable to be present at the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded. The auditor would also verify the procedure adopted, treatment given for the discrepancies noticed during the physical count. The auditor would also ensure that appropriate cut off procedures were followed by the management. He should also get management's written representation on (a) the completeness of information provided regarding the inventory and (b) assurance with regard to adherence to laid down procedures for physic inventory.

By following the above procedure it will be ensured that the physical verification conducted by the management was in order.

- (d) For initial audit engagement, the auditor should obtain sufficient appropriate audit evidences so that the
- (i) Opening balances of the preceding period have been correctly brought forward to the current period and
 - (ii) Opening balances do not contain misstatements that materially affect the financial statement of the current period (AAS 22).

Being a new assignment audit evidence regarding opening balances can be obtained by

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For current assets and liabilities some audit evidence can ordinarily be obtained as part of audit procedures during the current period. For example, the collection/payment of opening balances of receivables and payables will provide audit evidence as to their existence, rights and obligations, completeness and valuation at the beginning of the period.

In respect of other assets and liabilities such as fixed assets, investments long term debt, the auditor will examine the records relating to opening balances. The auditor may also be able to get confirmation from third parties (e.g., balances of long term loan obtained from banks).

Question 2

Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules there to:

- (a) CA X was appointed as the Auditor of ABC Ltd. for 2007-08. Since he declined to accept the appointment, the Board of Directors appointed CA Y as the auditor in the place of CA X, which was also accepted by CA Y. (4 Marks)
- (b) CA Z who is a leading Income Tax Practitioner and consultant in Jaipur is also trading in derivatives. (4 Marks)
- (c) CA D, a Chartered Accountant prepared a project report for one of his clients to obtain bank finance (long-term) of Rs.50 lakhs from a Commercial Bank. Consequent to the sanction of the loan by the bank CA D raised a bill for his services @ 2% of the loan sanctioned. (4 Marks)
- (d) CA ZZ who conducted ABC audit of a marathi daily 'New Era' certified the circulation figures based on Management Information System Report (M.I.S Report) without examining the books of Account. ((4 Marks)

Answer

- (a) 1. Board can appoint the auditor in the case of casual vacancy under Sections 224 (5) & 6(a) of the Companies Act, 1956.
- 2. The non-acceptance of appointment by CA. X does not constitute a casual vacancy to be filled by the Board.
- 3. In this case, it will be deemed that no auditor was appointed in the AGM.
- 4. Hence the appointment of auditor can be made only by the Central Government and the Board appointment is defective in law.
- 5. Clause 9 of Part-I of First Schedule states that a chartered accountant is deemed to be guilty of professional misconduct if he "Accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of section 225

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6. Hence CA. Y is guilty of professional misconduct since he accepted the appointment without verification.
- (b) 1. As per clause 11 of Part-I of First Schedule of CA Act, 1949, a Chartered Accountant is deemed to be guilty of professional misconduct if he "engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage".
2. However, the Council has granted general permission to the members to engage in 12 specific occupation. In respect of all other occupations specific permission of the Institute is necessary.
3. In this case CA Z is engaged in the occupation of trading in derivatives which is not covered under the general permission.
4. Hence specific permission of the Institute has to be obtained otherwise he will be deemed to be guilty of professional misconduct under clause 11 of Part-I of First Schedule of CA Act, 1949.
- (c) Clause 10 of part I to First Schedule to the Chartered Accountants Act prohibits a Chartered Accountant in practice to charge, to offer, to accept or accept fees which are based on a percentage of profits or which are contingent upon the findings or results of such work done by him.

However, this restriction is not applicable where such payment is permitted by the Chartered Accountants Act, the Council of the Institute has framed regulation 192 which exempts certain professional services from the operation of clause 10.

The services rendered by CA. D are not covered under the said exemption and hence CA. D is liable for professional misconduct.

- (d) 1. According to clause 7 of Part-I of Second Schedule of Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he "does not exercise due diligence or is grossly negligent in the conduct of his professional duties".
2. In the instant case CA ZZ did not exercise due diligence and is grossly negligent in the conduct of his professional duties since he certified the circulation figures without examining the books of accounts.
3. To ascertain the number of paid copies verification of remittances from the agents, credit allowed to the agents for unsold copies returned, examination of books of account is essential.
4. Further certification of circulation figures based on statistical information without cross verification with financial records amounts to gross negligence and failure to exercise due diligence.
5. Hence CA ZZ is guilty of professional misconduct as per clause 7 of part I of

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Question 3

- (a) The auditor must evaluate major clauses of control used in a Computerised Information system to enhance its reliability – Comment. (8 Marks)
- (b) You have been appointed as the auditor of a Multiplex Cinema House. Draw an audit programme in respect of its Revenue and Expenditure. (8 Marks)

Answer

- (a) The reliability of a component is a function of control that acts on the component. In a computer system the following are the major types of controls are used to enhance component reliability which the auditor must evaluate:
- (1) Authenticity Control: They are exercised to verify the identity of the individuals or process involved in a system. (Pass word, digital signature etc.)
 - (2) Accuracy Control: These attempts to ensure the correctness of the data and processes in a system (Programme validation check).
 - (3) Completeness Control: This ensures that no data is missing and all processing is carried through to its proper conclusion.
 - (4) Privacy Control: This ensures the protection of data from inadvertent or unauthorised disclosure.
 - (5) Audit Trail Controls: This ensures the traceability of all events occurred in a system.
 - (6) Redundancy Control: It ensures that processing of data is done only once.
 - (7) Existence Control: It attempts to ensure the on going availability of all system resources.
 - (8) Asset safeguarding controls: It attempts to ensure that all resources within a system are protected from destruction or corruption.
 - (9) Effectiveness Control: It attempts to ensure that the system achieves its goals.
 - (10) Efficiency Control: It attempts to ensure that a system uses minimum resources to achieve its goals.
- (b) Audit Programme of Multiplex
1. Peruse the Memorandum of Association and Articles of Association of the entity.
 2. Ensure the object clause permits the entity to engage in this type of business.
 3. In the case of income from sale of tickets:
 - (a) Verify the control system as to how it is ensured that the collections on sale of tickets of various shows are properly accounted.
 - (b) Verify the system of relating to on line booking of various shows and the system of realization of money.

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- (c) Check that there is overall system of reconciliation of collections with the number of seats available for different shows on a day.
4. Verify the internal control system and its effectiveness relating to the income from cafes shops, pubs etc., located within the multiplex.
 5. Verify the system of control exercised relating to the income receivable from advertisements exhibited within the premises and inside the hall such as hoarding, banners, slides, short films etc.
 6. Verify the system of collection from the parking areas in respect of the vehicles parked by the customers.
 7. In the case of payment to the distributors verify the system of payment which may be either through out right payment or percentage of collection or a combination of both. Ensure at the time of settlement any payment of advance made to the distributor is also adjusted against the amount due.
 8. Verify the system of payment of salaries and other benefits to the employees and ensure that statutory requirements are complied with.
 9. Verify the payments effected in respect of the maintenance of the building and ensure the same is in order.

Question 4

- (a) State the main features of the Qualified and Independent Audit Committee set up under clause 49 of the listing agreement. (8 Marks)
- (b) As Auditor of Act Fast Ltd. what steps will you take to ensure that the dividend has been paid only out of profit? (8 Marks)

Answer

- (a) The main features of a qualified and independent audit committee to be set up under clause 49 of listing agreement are as follows:
 - ◆ The audit committee shall have minimum three directors as members; Two-thirds of the members of the committee shall be independent directors.
 - ◆ All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.
 - ◆ The term, "financially literate", shall mean the ability to read and understand basic financial statements i.e., balance sheet, profit and loss account and statement of cash flows.
 - ◆ A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting or professional certification in these areas.

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- ◆ The Chairman of the committee shall be present at the annual general meeting to answer shareholder queries.
 - ◆ The audit committee may invite executives, the finance director, head of internal audit and a representative of the statutory auditor.
 - ◆ The Company Secretary shall act as the secretary to the committee.
- (b) The auditor may take the following steps to ensure that the dividend has been paid only out of profits.
1. Check whether the dividend was declared out of profits arrived at after providing for depreciation.
 2. If no depreciation has been provided, ensure that the approval was obtained from the Central Government before declaring dividend.
 3. Check whether
 - (i) The depreciation was provided according to provision of section 205(2).
 - (ii) The minimum prescribed amount has been transferred to reserves before declaring any dividend.
 - (iii) Conditions governing transfer of higher percentage is complied with.
 - (iv) A board resolution recommending dividend was passed.
 - (v) Dividend was declared (resolution was passed) only in the Annual General Meeting.
 - (vi) Dividend has been paid in the prescribed manner within 30 days of time to the registered holder or their order.
 - (vii) Amount of dividend deposited in a separate bank account within five days from the date of declaration of dividend.
 - (viii) Permission of Reserve Bank of India has been obtained for payment to non-resident shareholders before the remittance of dividend to their account.
 - (ix) Intimation sent to Stock Exchange in the case of listed company.
 - (x) There were any complaints of non payment/delayed payment of dividend and the corrective action taken.

Question 5

- (a) As the auditor of LMN Ltd. you notice certain differences in the figures between the books of account and offer document. The company explains that it is due to certain adjustments made as per SEBI (Disclosure and Investor Protection) Guideline, 2000. State such disclosure and adjustments which are to be incorporated in the Financial Statement of the offer document.

Tax, Sales Tax, Wealth Tax, Customs duty, Excise duty, Cess and any other statutory dues with the appropriate authorities and if not, the extent of arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable shall be indicated by the auditor.

- (ii) Whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty percent of its net worth and whether it has incurred cash losses in such financial year and in the immediately preceding financial year.

Answer

- (a) SEBI (Disclosure and Investor Protection) Guidelines, 2000 require following disclosure and adjustment in the financial statement which is to be incorporated in the offer document:
- (a) All significant accounting policies and standards followed in the preparation of the financial statement shall be disclosed.
- (b) Statement of assets and liabilities and profit and loss or any other financial information shall be incorporated after making the following adjustments, wherever quantification is possible.
- (i) Adjustments/rectification for all incorrect accounting policies or failures to make provisions or other adjustments which resulted in audit qualifications.
- (ii) Material amount relating to adjustments for previous years shall be identified and adjusted in arriving at the profit for the year to which they relate, irrespective of the year in which the event triggering the profit or loss occurred.
- (iii) Where there has been change in accounting policy, the profits or losses of the earlier years and of the year in which the change has taken place shall be recomputed to reflect what the profits or losses would have been if a uniform accounting policy was followed in each of these years. However, if an incorrect accounting policy is being followed the recomputation of the financial statement would be in accordance with correct accounting policies.
- (iv) Statement of profit or loss shall disclose both the profit and loss before and after considering the profit or loss from extraordinary items.
- (v) The statement of assets and liabilities shall be prepared after deducting the balance outstanding on revaluation reserve account from both fixed assets and reserve and the net worth arrived at after such deduction.
- (b) (i) (1) The auditor has to report upon regularity of the company in depositing undisputed statutory dues.
- (2) If the company is not regular in depositing the undisputed statutory dues the

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- (3) The payment includes all other statutory dues payable by the company.
 - (4) The amount payable will include the interest/penalty payable under the respective laws.
 - (5) The auditor has to get a written representation from the management indicating the details of disputed claims, undisputed but have remained outstanding for more than six months and a statement as to the completeness of the information provided by the management.
- (b) (ii)
1. This clause is applicable to all the companies which are in existence for more than five years.
 2. The auditor has to report (i) whether the accumulated losses at the end of the financial year are more than 50% of its net worth and (ii) whether the company has incurred cash losses during the period covered by the report and in the immediate previous year.
 3. The term loss should be construed to mean the net profit/loss shown by the P & L a/c of the company as adjusted after taking into account qualifications in the audit report to the extent qualifications are quantified.
 4. Net worth is defined as sum of total paid up capital and free reserves after deducting the provisions or expenses as may be prescribed.
 5. Free reserve means all reserves created out of profits and share premium but does not include reserves created out of revaluation of assets, write back of depreciation provisions and amalgamation.
 6. The auditor has to indicate his opinion on the above and the effect of qualifications.

Question 6

- (a) (i) What do you understand by Long-form Audit Report? (2 Marks)
- (ii) As the concurrent auditor of Nagpur Main Branch of XYZ Bank Ltd. state the issues which have to be considered in the audit of advances. (6 Marks)
- (b) As the auditor of an Insurance company state the audit procedure you would follow to verify outstanding premium and agents balances. (4 Marks)
- (c) You are the auditor of IJK Ltd., a NBFC registered with RBI. How would you proceed to ensure the compliance of Prudential Norms directions by it. (4 Marks)

Answer

- (a) (i) The long form Audit Report has to be furnished by the auditor of a bank in addition to the audit report as per the statutory requirement. The matters which the banks require their auditor to deal with in the form of Long Form Audit Report have been specified by to Reserve Bank of India.

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- (1) Ensure that loans and advances are sanctioned properly.
 - (2) Verify whether the sanctions are in accordance with the delegated authority.
 - (3) Ensure that securities and documents have been received and properly charged/registered.
 - (4) Ensure that post disbursement supervision and follow up is proper.
 - (5) Verify whether there is any misuse of loans and advances and whether there are instances indicative of diversion of funds.
 - (6) Check whether letters of credit issued by the branch are within the delegated power and ensure that they are genuine trade transactions.
 - (7) Check bank guarantees issued are properly worked and recorded.
 - (8) Ensure proper follow up of over due bills of exchange.
 - (9) Verify the classifications of advances are as per RBI directions.
 - (10) Verify whether the submission of claims to DICGC and ECGC is in time.
 - (11) Verify the instances of exceeding delegated powers have been promptly reported.
 - (12) Verify the frequency and genuineness of such exercise of authority beyond to delegated powers of the concerned officials.
- (b) The following are the audit procedure to be followed for verification of outstanding premium and agents balances in the case of Insurance Company.
- (1) Scrutinise and review control account debit balances and their nature should be enquired into.
 - (2) Examine in operative balances and treatment given for old balances with reference to company rules.
 - (3) Enquire the reasons for returning the old balances.
 - (4) Verify old debit balances which may require provision or adjustment. Notes of explanation may be obtained from the management in this regard.
 - (5) Check age-wise, sector-wise analysis of outstanding premium.
 - (6) Verify whether outstanding premiums have since been collected.
 - (7) Check the availability of adequate bank guarantee or premium deposit for outstanding premium.
- (c) Compliance of Prudential Norms by NBFC
1. The auditor has to verify the compliance of prudential norms relating to (1) income recognition; (2) Income from investments; (3) Asset classification; (4) Provision for bad and doubtful debts; (5) Capital adequacy norm; (6) Prohibition of granting loans

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- against its own shares; (7) Prohibition on loans and investments for failure to repay public deposits and (8) Norms for concentration of credit etc.
2. The auditor shall ensure that Board of the NBFC shall frame a policy for granting demand/call loans and implement the same.
 3. The auditor should verify the classification of advances and loans as standard/substandard/doubtful/loss and that proper provision has been made in accordance with the directions.
 4. Auditor should ensure that unrealised income from non-performing assets has not been taken to profit and Loss Account.
 5. The auditor should check all NPAs of the previous years to verify whether during the current year any payments have been received or still they continue to be NPA during the current year also.

Question 7

Write short notes on the following:

- (a) Circuit filters/Circuit breakers. (4 Marks)
- (b) General principles relating to propriety aspect. (4 Marks)
- (c) Frauds through supplier ledger. (4 Marks)
- (d) Purpose of appointing Inspecting officer of a Depository. (4 Marks)

Answer

Short Notes

- (a) Circuit Filters/Circuit Breakers:
 - (i) This is the price band that set the upper and lower limit within which a stock can fluctuate on any particular day.
 - (ii) A price band for a day is a function of the previous days closing price.
 - (iii) According to SEBI directions circuit filter is applied on scrips traded in rolling settlement, if their price fluctuate more than 10% of the closing price of scrip on the previous day.
 - (iv) Thus circuit filters restrict extreme price movement and resist price manipulation.
 - (v) This also protects investor from extreme fluctuations.
- (b) General principles to be confirmed by Propriety
 - (i) The expenditure is not prima facie more than the occasion demands and that every official exercises the same degree of vigilance in respect of expenditure as a person of ordinary prudence.

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- (iii) That the funds are not utilised for the benefit of a particular person or group of persons and
 - (iv) That, apart from the agreed remuneration or reward, no other revenue is kept open to indirectly benefit the management personnel, employees or others.
- (c) Frauds through suppliers ledger
- Fraud through supplies ledger could be made in any of the following ways, which the auditor has to take case of:
- (1) Adjusting fictitious as duplicate invoices as purchases in the accounts of suppliers and subsequently misappropriating the money when payments are made in respect of these invoices.
 - (2) Suppressing credit notes issued by suppliers and withdrawing the corresponding amount not claimed by them.
 - (3) Withdrawing amounts which remain unclaimed for more than the normal time limit for one reason or other by showing the same have been paid to the parties.
 - (4) Accepting invoices at prices considerably highest than the market price and collecting the excess claim from the suppliers directly.
- (d) SEBI appoints inspecting officers to investigate or inspect the affairs of a depository for any of the following purposes.
- (1) To ensure that the books of accounts are maintained in the names specified in the regulations
 - (2) To look into the complaints received from depositors' participant, beneficial owners or other persons.
 - (3) To ascertain whether the provisions of the Act, bye-laws agreements and these regulations are being complied.
 - (4) To ascertain whether the systems, procedures and safeguards are being followed in the interests and to secure the market.
 - (5) To ensure that the affairs are being conducted in the interest of the Investors / Securities markets.

Question 8

- (a) Highlight the provisions relating to corporate responsibility under Sarbanes Oxley Act of 2002. (4 Marks)
- (b) Explain the objectives of Peer Review. (4 Marks)
- (c) State the important aspects to be considered by the External auditor in the evaluation of Internal Audit Function. (4 Marks)
- (d) State whether a Tax audit report can be revised and if so state those circumstances.

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Answer

(a) Corporate Responsibility under Sarbanes Oxley Act of 2002

- ◆ The audit committee to be more independent through enhancement of their oversight responsibilities and one of the Audit committee members to be financial expert.
- ◆ Requires CEO & CFO to issue certification of the quarterly financial results and annual reports to SEC as part of compliance with Form 10K
- ◆ Provides rules of conduct for companies managerial and their officers regarding.
- ◆ Pension matters.
- ◆ To Comply with SEC rules requiring attorneys to report violation of securities to the company's CEO or chief legal counsel & to Audit Committee if no action is taken.

(b) Objectives of Peer Review

- (1) To ensure that members while performing attestation services comply with technical standards issued by the Institute;
- (2) To ensure that such a member has in place proper system (including documentation system) for maintaining the quality of attestation services performed by him;
- (3) To ensure adherence to various statutory and regulatory requirements and
- (4) To enhance the reliance placed by the users of financial statements from economic decision making.

(c) Evaluation of Internal Audit function by external auditor.

The important aspects are as follows:

(i) Organizational Status:-

- The Internal audit has to be an independent function reporting to the highest level of management
- The internal auditors should be free to communicate fully with the external auditor.

(ii) Scope of function

Nature and depth of coverage of internal audit function.

To ascertain to what extent the management considers and where appropriate acts upon internal audit recommendations.

(iii) Technical Competence

- ◆ To ascertain that the 2A work is performed by persons having adequate technical training and proficiency.

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- (iv) Due Professional care
 - ◆ To ascertain whether the internal audit worker is properly planned, supervised, reviewed and documented
 - ◆ To verify the assistance of adequate audit manuals, audit programmes and working papers.
- (d) (a) Normally, the report of the tax auditor cannot be revised later
- (b) However, when the accounts are revised in the following circumstances, the tax Auditor may have to revise his Tax audit report also.
 - (i) Revision of accounts of a company after its adoption in the annual general meeting.
 - (ii) Change in law with retrospective effect.
 - (iii) Change in interpretation of law (e.g.) CBDT Circular, Notifications, Judgments, etc.

The Tax Auditor should state it is a revised Report, clearly specifying the reasons for such revision with a reference to the earlier report.