PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

*Answer **all** questions.*

Question 1

Comment on the following:

(a) 'A' Limited has paid minimum alternate tax under Section 115 JB of the Income Tax Act, 1961, for the year ended 31st March, 2009. The company wants to disclose the same as an 'Asset' since the company is eligible to claim credit for the same. (5 Marks)

(b) XYZ Limited received a grant of Rs.25 lakhs under the Government's Subsidy Scheme, for acquiring an imported machinery for setting up new plant. The entire grant received is credited to Profit and Loss Account. (5 Marks)

(c) Moon Limited replaced its statutory auditor for the Financial year 2008-09. During the course of audit, the new auditor found a credit item of Rs.5 lakhs. On enquiry, the company explained him that it is, a very old credit balance. The creditor had neither approached for the payment nor he is traceable. Under the circumstances, no confirmation of the credit balance is available. (5 Marks)

(d) The statutory audit of Fortune Limited for the year ended on 31.03.2009 was completed and auditor also submitted his report with the audited Financial Statements to the management of the company. Thereafter, the management of the company approached the auditor to revise certain items in the Financial Statements. (5 Marks)

Answer

(a) As per para 6 of the Guidance Note issued by ICAI on "Accounting for credit available in respect of MAT under the IT Act, 1961", although MAT credit is not a deferred tax asset under AS 22, yet it gives rise to expected future economic benefit in the form of adjustment of future income tax liability arising within the specific period.

The Framework for the preparation and presentation of financial statements, issued by the ICAI, defines the term 'asset' is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

MAT paid in a year in respect of which the credit is allowed during the specified period under the Income Tax Act is a resource controlled by the company as a result of past event, namely the payment of MAT. The MAT credit has expected future economic benefits in the form of its adjustment against the discharge of the normal tax liability if the same arises during the specified period. Accordingly, such credit is an asset.

According to the Framework, once an item meets the definition of the term 'Asset', it has to meet the criteria for recognition of an asset, so that it may be recognised as such in the financial statements.

Para 88 of the Framework provides the following criteria for recognition of an asset:

An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

Thus, if the auditor is satisfied that the probability of the company to claim the said credit is high, it could recognise the same as an asset. In balance sheet it could be shown under the head "Loans and Advances" as MAT credit entitlement.

(b) According to AS 12, "Accounting for Government Grants" where grant is received for the acquisition of a specific fixed asset, the same cannot be credited to Profit and Loss Account since it fails to match revenue with the cost.

As per AS 12, such grants should be presented in the balance sheet showing the grant as a deduction from the gross value of the asset concerned (in arriving at its book value). Alternately, the grants related to a depreciable fixed asset may be treated as deferred income which should be recognised in the profit and loss account on a systematic and rational basis over the useful life of the asset. By crediting the entire amount of grant to profit and loss account, the company has treated it as a revenue income which is not in accordance with the requirements of the accounting standard.

Therefore, the statutory auditor would have to qualify appropriately that the income has been overstated to the extent of the amount of grant net of proportionate credit that would have been worked out.

(c) This is a case of external confirmation, covered by SA 505 "External Confirmation". The identities of creditors are not traceable to confirm the credit balance as appearing in the financial statement of the company. It is also not a case of pending litigation.

It might be a case that an income of Rs.4 lakhs had been hidden in previous year/s. The statutory auditor should examine the validity of the credit balance as appeared in the company's financial statements. He should obtain sufficient evidence in support of the balance. He should apply alternative audit procedures to get documentary proof for the transaction/s and should not rely entirely on the management representation. Finally, he should include the matter by way of a qualification in his audit report to the members.

(d) As per the Guidance Note on Revised Accounts of Companies Before Circulation to Shareholders, management can revise its accounts after adoption on which report has been issued by the Auditors, but before circulation to the shareholders.

In the instant case, the statutory auditor should ascertain whether the original audit report along with audited accounts has been circulated to the share-holders. If not, he can issue a revised report on the amended financial statements as laid down by the said Guidance Note:

(i) For the same, the revised accounts must be re-approved by the Board of Directors of the company.

(ii) He should ask the company to return all the original copies of the earlier audit report along with the audited accounts.

(iii) The fact of revision of financial statements with reasons should be incorporated in the Directors' Report. If it is neither included nor found adequately disclosed in the Director's Report, he should include the fact with figures and reasons in his revised audit report to the shareholders. He should specifically mention that it is a revised audit report.

Question 2

Give your comments with reference to the Chartered Accountants Act, and schedules thereto:

(a) *Mrs. Fair is a Director of XYZ Private Limited, having 15% share-holdings in the company. During 2003, the company appointed C.A. Mr. Lovely, Mrs. Fair's spouse, as its statutory auditor. On Mr. Lovely's advice, the company issued fresh equity shares in 2003-04, in the ratio of one share for every two shares held by the shareholders of the company. Mr. Lovely used to deliver audit report for subsequent years without any comments or disclosures, thereupon.* *(4 Marks)*

(b) *Mr. A, a Chartered Accountant was the auditor of 'A Limited'. During the financial year 2007-08, the investment appeared in the Balance Sheet of the company of Rs.10 lakhs and was the same amount as in the last year. Later on, it was found that the company's investments were only Rs.25,000, but the value of investments was inflated for the purpose of obtaining higher amount of Bank loan.* *(4 Marks)*

(c) *An advertisement was published in a Newspaper containing the photograph of Mr. X, a member of the institute wherein he was congratulated on the occasion of the opening ceremony of his office.* *(4 Marks)*

(d) *Mr. X, a Chartered Accountant and the proprietor of X & Co., wrote several letters to the Assistant Registrar of Co-operative Societies stating that though his firm was on the panel of auditors, no audit work was allotted to the firm and further requested him to look into the matter.* *(4 Marks)*

Answer

(a) As per the Companies Act, 1956, the definition of 'Relative' includes husband and wife. In this case M and N are spouse of each other. Mr. Lovely should not accept the appointment as Statutory auditor of the company, where his wife M has vulnerable interest. Where the company issued fresh equity shares on N's advice, it is an apparent evidence of N's control and direction over the company. Because of fresh issue of equity shares, Mr. Lovely's shareholding became 22.5% (15% + 50% thereof) and thus his wife now has substantial interest (i.e. more than 20%) in the said company. Mr. Lovely did not declare such interest of his wife, as substantial shareholder in the company in his audit report/s of the subsequent years, as he never offered any comment.

The independence of the auditor would be compromised without a declaration of his substantial interest. So Mr. Lovely is therefore liable for misconduct.

(b) The primary duty of physical verification and valuation of investments is of the management. However, the auditor's duty is also to verify the physical existence and valuation of investments placed, at least on the last day of the accounting year. The auditor should verify the documentary evidence for the cost/value and physical existence of the investments at the end of the year. He should not blindly rely upon the ... ed for two years. It also appear that auditors failed to confirm the value of investments from any proper source. In case auditor has simply relied on the management's representation the auditor has failed to perform his duty. Accordingly, Mr. A, will be held liable for professional misconduct under clauses (2), (7) and (8) of Part -1 of the Second Schedule to the Chartered Accountants Act, 1949 in terms of Sections 21 and 22.

(c) Mr. X published an advertisement in a Newspaper containing his photograph on the occasion of the opening ceremony of his office. On this context, it may be noted that the advertisement which had been put in by the member is quite prominent. If soliciting of work is allowed, the independence and forthrightness of a Chartered Accountant in the discharge of duties can not be maintained.

The above therefore amounts to soliciting professional work by advertisement directly or indirectly. Mr. X would be therefore held guilty under Clause 6 of Part-I of the First Schedule to the Chartered Accountants Act, 1949.

(d) Mr. X, a Chartered Accountant and proprietor of M/s X and Co, wrote several letters to the Assistant Registrar of Co-operative Societies, requesting for allotment of audit work. In similar cases, it was held that the Chartered Accountant would be guilty of professional misconduct under clause 6 of Part I of the First schedule to the Chartered Accountants Act, 1949. The writing of continuous letter to ascertain the reasons for not getting the work is quite alright but in case such either amount to request for allowing the work than Mr. X will be liable for professional misconduct. In fact Mr. X would be therefore held guilty under clause 6 of Part I of the Act.

Question 3

Answer the following:

(a) Briefly explain:

(i) Audit procedures on subsequent events

(ii) Collection of evidences by Peer reviewer. *(8 Marks)*

(b) ABC Printing Press, a proprietary concern, made a turnover of above Rs.43 lacs for the year ended 31.03.2009. The Management explained its auditor Mr. Z, that it undertakes different job work orders from customers. The raw materials required for every job are dissimilar. It purchases the raw materials as per specification/requirements of each customer, and there is hardly any balance of raw materials remaining in the stock, except pending work-in-progress at the year end. Because of variety and complexity of materials, it is rather impossible to maintain a stock-register. Give your comments. *(5 Marks)*

(c) A Co-operative Society having receipts above Rs.40 lakhs gets its accounts audited by a person eligible to do audit under Co-operative Societies Act, 1912, who is not a Chartered Accountant. State with reasons whether such audit report can be furnished as tax audit report under Section 44 AB of the Income Tax Act, 1961? *(3 Marks)*

Answer

(a) (i) Audit Procedures on Subsequent Events

As per SA 560 "Subsequent Events", events occurring between the dates of balance sheet and audit report and the facts that become known to the auditor after the date of the auditor's report.

The Auditor should perform the following procedure to obtain sufficient appropriate evidence to find out the adjustments or disclosures of those subsequent events:

(i) Review the procedures adopted by the management to identify subsequent events.

(ii) Examine the minutes of the Board of Directors, Executive Committees and the General Meetings of the shareholders.

(iii) Collect information from the other sources like budgets/estimates, cash flows, forecasts, interim financial statements etc.

(iv) Make enquiries and hold discussions with the top management.

(v) Details from company's lawyers for any litigation matter.

(ii) Collection of Evidence by Peer Reviewer

A Peer Reviewer collects evidence by applying the following methods:

(a) *Inspection*: It includes scrutiny of documentation and other records of the practicing unit.

(b) *Observation*: He observes the procedures/processes followed in the production unit.

(c) *Enquiries*: He enquires and collects required information from the responsible person of practice unit, even by the use of questionnaire.

(b) The explanation of the entity for the use of varieties of raw materials for different jobs undertaken may be valid. But the auditor needs to verify the specified job-orders received and the different raw materials purchased for each job separately. The use of different papers (quality, quantity and size) ink, colour etc. may be examined. If possible, the auditor may also enquire with the other similar printers in the locality to ensure the prevailing custom. At the same time, he has to report and certify under the Para 28(b) and Para 9(b) of Form 3CD read with the Rule 6G(2) of the Income Tax Act, 1961, about the details of stock and account books (including stock register) maintained. He (or his deputy) must verify the closing stock of raw materials, work-in-progress and finished goods of the concern, at least on the date of its balance sheet. In case the said details are not properly maintained, he has to specifically mention the same with reasons for non-maintenance of stock register by the entity.

(c) Proviso to Section 44AB lays down that where the accounts of an assessees are required to be audited by or under any other law, it shall be sufficient compliance with the provisions of this section, if such person get the accounts of such organisation audited under such other [illegible] equired under such other law and a further report by an accountant in the form prescribed under this section.

In the case of any assessee like co-operative society where the accounts under the relevant law are allowed to be audited by a person other than a Chartered Accountant, the statutory auditor need not be a Chartered Accountant.

Thus, it shall be sufficient compliance with the provisions of this section and can be considered under section 44AB.

Question 4

Answer the following:

(a) *How will you evaluate the Internal Control system in the area of Credit Card operations of a Bank?* *(5 Marks)*

(b) *Enumerate the steps to be taken by an auditor for the verification of Re-insurance outward in case of a General Insurance Company.* *(5 Marks)*

(c) *Explain briefly duties and responsibilities of an auditor in case of material misstatement resulting from Management Fraud.* *(6 Marks)*

Answer

(a) Evaluation of Internal Control System in the area of Credit Card Operations in a bank:

(i) There should be effective screening of applications with reasonably good credit assessments.

(ii) There should be strict control over storage and issue of cards.

(iii) There should be a system whereby a merchant confirms the status of unutilised limit of a credit-card holder from the bank before accepting the settlement in case the amount to be settled exceeds a specified percentage of the total limit of the card holder.

(iv) There should be system of prompt reporting by the merchants of all settlements accepted by them through credit cards.

(v) Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards.

(vi) All the reimbursements (gross of commission) should be immediately charged to the customer's account.

(vii) There should be a system to ensure that statements are sent regularly and promptly to the customer.

(viii) There should be a system of monitor and follow-up of customers' payments.

(ix) Items overdue beyond a reasonable period should be identified and attended to carefully. Credit should be stopped by informing the merchants through periodic bulletins, as early as possible, to avoid increased losses.

(x) There should be a system of periodic review of credit card holders' accounts. On ... should also include determination of doubtful amounts and the provisioning in respect thereof.

(b) Steps under sub-regulation 4 of the IRDA (General Insurance – Re-insurance) Regulations, 2000

(1) The auditor should verify that re-insurance underwriting returns received from the operating units regarding premium, claims paid, outstanding claims tally with the audited figures of premium, claims paid and outstanding claims.

(2) The auditor should check whether the pattern of reinsurance underwriting for outward cessions fits within the parameters and guidelines applicable to the relevant year.

(3) The auditor should also check whether the cessions have been made as per the stipulation applicable to various categories of risk.

(4) The auditor should verify whether the cessions have been made as per the agreements entered into with various companies.

(5) It should also be seen whether the outward remittances to foreign re-insurers have been done as per the foreign exchange regulations.

(6) It should also be seen whether the on cessions have been calculated as per the terms of the agreements with the re-insurers.

(7) The auditor should verify the computation of profit commission for various automatic treaty arrangements in the light of the periodical accounts rendered and in relation to outstanding loss pertaining to the treaty.

(8) The auditor should examine whether the cash loss recoveries have been claimed and accounted on a regular basis.

(9) The auditor should also verify whether the claims paid item appears in outstanding claims list by error. This can be verified at least in respect of major claims.

(10) He should see whether provisioning for outstanding losses recoverable on cessions have been confirmed by the re-insurers and in the case of major claims, documentary support should be insisted and verified.

(11) Accounting aspects of the re-insurance cession premium, commission receivable, paid claims recovered, and outstanding losses recoverable on cessions have to be checked.

(12) The auditor should check percentage pattern of gross to net premium, claims paid and outstanding claims to ensure comparative justification.

(13) The auditor should also check that the re-insurers balance on cessions and whether the sub ledge balances tallies with the general ledger balance.

(14) The auditor should review the individual accounts to find out whether any balance requires provisioning/write off or write back.

(15) He should verify whether the balances with re-insurers are supported by necessary confirmation obtained from them.

(16) He should verify whether opening outstanding claims not paid during the year find anding

losses recoverable on cessions appears in both opening and closing list. If not, the reason for the same should be analysed.

(17) Any major event after the balance sheet date which might have wider impact with reference to subsequent changes regarding the claim recovery both paid and outstanding and also re-insurance balances will need to be brought out suitably.

(c) Duties & Responsibilities of an auditor in case of Material misstatement resulting from management fraud

Misstatement in the financial statements can arise from fraud or error. The term fraud refers to an 'Intentional Act' by one or more individuals among management, those charged with governance. The auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements.

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

SA 200A (AAS 2) indicates that an audit conducted in accordance with the standards on auditing generally accepted in India, is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement whether caused by error or fraud. The fact that an audit is carried out may act as deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of financial statements will not be detected, even though the audit is properly planned and performed in accordance with the standards on auditing generally accepted in India. An audit does not guarantee that all material misstatement will be detected because of such factors, as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.

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

Question 5

Answer the following:

(a) State briefly eight provisions of the Sarbanes-Oxley Act of 2002, which shall, if strictly applied to Indian Corporates, get fruitful results. *(8 Marks)*

(b) Discuss briefly Accounting standards to be followed by assessees under the Income-tax Law. *(4 Marks)*

(c) Under what circumstances, an auditor is required to submit a special report to the registrar of Co-operative Societies? *(4 Marks)*

Answer

(a) Following are some provisions of the Sarbanes-Oxley Act of 2002, which, if enacted in India may be further fruitfull is respect of Indian corporate:

1. More independence be given to Audit Committee and auditor.
2. Ban on personal loan to Directors / Executive Officers of a Company
3. Strict reporting by an auditor on insider trading.
4. Additional disclosures imposed on financial reporting.
5. If there is any conflict between company and its auditor, the Audit Committee should be empowered to resolve the same.
6. Higher penalties and criminal prosecution on financial frauds.
7. To include effectiveness of Internal Control System in the financial reporting.
8. More responsibilities must be imposed on managerial personal with higher penalties and prosecutions on the breach.
9. Strict action against white collar crime.
10. Disclosers of the % of shareholdings by Directors, Executive Officers and principal shareholders.

(b) ***Accounting Standards under the Income Tax Law***: The Finance Act, 1995, substituted a new Section 145 w.e.f. 1997-98. The section deals with method of accounting as under:

145 (1) Income chargeable under the head '*Profit and gains of business and profession*' or '*Income from other sources*' shall, subject to the provisions of sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.

145(2) The Central Government may notify in the Official Gazette from time to time accounting standards to be followed by any class of assessees or in respect of any class of income.

145 (3) Where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the assessee, or where method of accounting provided in the Sub-section 10 or accounting standards as notified under Section (2) above have not been regularly followed by the assessee. The Assessing Officer may make an assessment in a manner provided in Section 144 of the Income Tax Act.

The Central Government has by Notification No. S. O. 69 (E), dated 25.01.1996, prescribed. As (IT) as under:

A. Accounting Standard I relating to Disclosure of accounting policies.

B. Accounting Standard II relating to Disclosure of Prior Period and Extraordinary Items and Changes in Accounting Policies.

The above Accounting Standards are to be followed by all assessee following mercantile system of accounting. Therefore, it is clear that those assessees who are following cash system of accounting need not follow the Accounting Standards notified above.

(c) Under the following circumstances, an auditor has to issue special report to the Registrar of Co-operative Societies (This report should be in addition to the regular report) :

1. (a) Any member of the managing committee is involved in personal profit making by using the properties or assets of the society, resulting into the loss to the society.

   (b) Frauds are detected from the society's transactions.

2. There is mismanagement in the society and the principles of co-operative are not maintained by the management.

3. In the respect of audit of Urban Co-operative Banks, disproportionate advances to vested interest groups. Such as relative of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

Question 6

Answer the following:

(a) The role of an auditor in collecting audit evidences under EDP system is more complex than under the manual system - Discuss. *(8 Marks)*

(b) What do you understand about Reserved Capital as provided under Section 99 of the Companies Act, 1956? How is it different from Capital Reserve? *(4 Marks)*

(c) Explain briefly the Flow Chart technique for evaluation of the Internal Control system. *(4 Marks)*

Answer

(a) Collecting evidence on the reliability of an EDP system is more complex than collecting evidence on the reliability of manual system. Auditors can be faced or confronted with a diverse and sometimes complex range of EDP systems depending upon technology that did not exist in manual systems. For example, accurate and complete operation of a disc drive required a set of hardware controls not used in a manual system. Similarly, system development controls include procedures for testing programs that would not be found in the development of manual systems. Auditors must understand these controls if they are to be able to collect evidence competently on the reliability of the controls.

Unfortunately, understanding the changing technology is not easy. Hardware and software continue to evolve rapidly and although there is some time lag, the associated controls evolve rapidly also. Auditors must keep upto-date with the developments if they are to be able to evaluate the reliability of accounting system.

The continuing evolution of computer technology also makes it more difficult for auditors to ain the evidence using manual means. Thus auditors need EDP systems themselves if they are to be able to collect the necessary evidence. The development of generalised audit software occurred, for example, because auditors needed access to data maintained on magnetic media. Similarly, new audit tools may be required, in due course, to evaluate the controls.

(b) ***Reserve Capital***

As per Section 99 of the Companies Act, 1956, a limited company may, by a Special Resolution determine a portion of its share capital not being called-up, is to be kept reserved and shall be called-up, in the event and for the purpose of being wound-up.

Capital Reserve

Certain capital profit is transferred to Capital Reserve, which is not a free-reserve. It is not available to distribute as dividend to shareholders. It is generally utilised to write-off capital losses. For example, Profit on re-issue of forfeited shares.

(c) ***Flow-Chart Technique for evaluation of Internal Control***

This technique can be resorted to for evaluation of the Internal Control System. It is a graphic presentation of internal controls in the organisation and is normally drawn up to show the controls in each section or sub-section.

As distinct from a narrative form, it provides the most concise and comprehensive way for reviewing the internal controls and the evaluator's findings. In a flow chart narratives , are reduced to the minimum and by that process, it can successfully bring the whole control structure, specially the essential parts thereof, in a condensed but wholly meaningful manner. Every details relevant from the control point of view and the details about how an operation is performed can be included in the flow-chart.

Essentially, a flow chart is a diagram full with lines and symbols and if judicious use of them can be made, it is probably an effective way of presenting the state of internal controls in the client's organisation. A properly drawn up flow chart can provide a neat visual picture of the whole activities of the section or department involving flow of documents and activities. More specifically it can show –

(i) at what point a document is raised internally or received from external sources;

(ii) the number of copies in which a document is raised or received;

(iii) the intermediate stages set sequentially through which the document and the activity pass;

(iv) distribution of the documents to various sections, department or operations;

(v) checking authorisation and matching at relevant stages;

(vi) filing of the documents; and

(vii) final disposal by sending out or destruction.

A flow chart is normally a horizontal one in which documents and activities are shown to flow horizontally from section to section and concerned sections are shown as the vertical column needs. These can be sales, purchase, wages, production etc.

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and collections. By this process, a flow chart will become self contained, complete and meaningful for evaluation of internal controls. Generally, a questionnaire is also enclosed with a flow chart, incorporating questions, the answers to which are to be looked into from the flow chart.