PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

Question No. 1 is compulsory.

Answer any five from the rest.

Question 1

Comment on the following:

(a) A Co. Ltd. has not included in the Balance Sheet as on 31-03-2010 a sum of ₹ 1.50 crores being amount in the arrears of salaries and wages payable to the staff for the last 2 years as a result of successful negotiations which were going on during the last 18 months and concluded on 30-04-2010. The auditor wants to sign the said Balance Sheet and give the audit report on 31-05-2010. The auditor came to know the result of the negotiations on 15-05-2010. (5 Marks)

(b) B Co. Ltd. is engaged in the business of developing mass scale housing projects including development of small commercial complexes. The flats/commercial spaces are booked by the public and are allotted by way of allotments letter to each allottee. Major construction activities pertaining to buildings are undertaken after allotment is over. After completing the construction, possession of flats/commercial spaces is given to allottees by executing legal document. The CEO of the B Co. Ltd. says that AS 7 is not applicable to the company. (5 Marks)

(c) In the notes to accounts of C Co. Ltd. as on 31-03-2010 Note no. 11 states that 'Certain machinery items are lying at customs warehouses and company has paid ₹ 900 lakhs up to 30-06-2009 as detention charges, out of which a sum of ₹ 580 lakhs is written back during the year 2009-10 based on settlement with the concerned authorities in respect of a major spares of machinery. For the remaining machinery items negotiations are pending and a provision of ₹ 44 lakhs is made. As such total amount of ₹ 364 lakhs paid/provided on account of detention charges have been capitalized and included in the Fixed Assets/Capital work in progress. The management is of the view that these expenses are directly attributable to the acquisition of the related Fixed Asset. (5 Marks)

(d) During the course of audit of D Co. Ltd. you as an auditor have observed that Inter Corporate deposit of ₹ 50 lakhs has been overdue. The D Co. Ltd. have disclosed this in the notes to accounts note No. 15 in schedule no. 21 stating that ₹ 50 lakhs is overdue from XYZ Co. Ltd. and the said company is in the process of liquidation. The management is taking steps to appoint the liquidator. (5 Marks)

Answer

(a) This case requires attention to SA 560 "Subsequent Events", AS 4 "Contingencies and Events occurring after the Balance Sheet Date" and AS 29 "Provisions, Contingent liabilities and Contingent Assets".

As per AS 4 "Contingencies and Events occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. Similarly as per AS 29 "Provisions, Contingent liabilities and Contingent Assets", 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 will occur.

In the instant case, the amount of ₹1.50 crores is a material amount and it is the result of an event, which has occurred after the Balance Sheet date. The facts have become known to the auditor before the date of issue of the Audit Report and Financial Statements.

The auditor has to perform the procedure to obtain sufficient, appropriate evidence covering the period from the date of the financial statements i.e. 31-3-2010 to the date of Auditors Report ie.31-05-2010. It will be observed that as a result of long pending negotiations a sum of ₹ 1.50 cores representing arrears of salaries of the year 2008-09 and 2009-10 have not been included in the financial statements. It is quite clear that the obligation requires provision for outstanding expenses as per AS 4 and AS 29.

As per SA 560 "Subsequent Events", the auditor should assure that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

So the auditor should request the management to adjust the sum of ₹1.50 crores by making provision for expenses. If the management does not accept the request the auditor should qualify the audit report.

(b) The contention of the CEO of B Co. Ltd. is correct. AS 7 "Construction Contract", should be applied in accounting for construction contracts in the financial statements of contractors.

The activity of the B Co. Ltd. is not that of a contractor. The company is developing projects on its own account as a commercial venture and is in the nature of production activity and not that of a contractor. Therefore AS 7 will not be applicable to B Co. Ltd.

For the purpose of recognition of Revenue and valuation of inventories B Co. Ltd. should follow the principles contained in AS 9 "Revenue recognition" and AS 2 " Valuation of Inventories".

(c) As per AS 10 "Accounting for Fixed Assets", the cost of an item of fixed asset comprise its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use.

Generally, detention charges represent an abnormal expenditure, as these expenditures are not directly attributable to the cost of asset.

The auditor will qualify the report appropriately in the paragraph before stating that the balance sheet gives true and fair view and the profit and loss account shows true and fair profit of the year ending on 31-3-2010. The qualification will be as follows:

"Attention is invited to Note no. 11 regarding Capitalization of detention charges of ₹ 364 lakhs during the year and on account of delays in respect of clearing from custom ...re not directly attributable to the acquisition of related fixed assets. The said amount of ₹ 364 lakhs should have been written off in the Profit and Loss account. Had these expenses been so written off the profit for the year would have been lower by ₹ 364 lakhs and Reserves & Surplus as well as Fixed Assets/Capital WIP would have been lower by ₹ 364 lakhs."

(d) As per AS 4 "Contingencies and Events occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date.

In the instant case, it appears from the note no 15 that the overdue of outstanding inter corporate deposit may not be realisable in full. The company is in the process of liquidation, makes it clear that on the balance sheet date, the amount of deposit is not safe and is not likely to be realised.

Therefore as per AS 4 provision for the loss is required in the accounts. Hence the auditor should qualify the Audit Report.

Question 2

Give your comments with reference to the Chartered Accountants Act, 1949 and schedules thereto:

(a) PQR and Associates, Chartered Accountants have their website and on the letterhead of the firm it is mentioned that "Visit our website: PQR com". In the website the nature of assignments handled, names of prominent clients and fees charged is also displayed.

(4 Marks)

(b) Mr. B is a practising Chartered Accountant holding a valid certificate of practice. He accepted the appointment as Director of the Green World Co. Ltd. Mr. C, a partner of Mr. B is statutory auditor of the said company. *(4 Marks)*

(c) YKS & Co., a proprietary firm of Chartered Accountants was appointed as concurrent auditor of a bank. YKS used his influence for getting some cheques purchased and thereafter failed to repay the loan/overdraft. *(4 Marks)*

(d) Mr. Mohan is a practising Chartered Accountant. He issued a certificate of consumption which did not reflect the correct factual position of the consumption of raw material by the concerned entity. It is found that the certificate is given on the basis of data appearing in the minutes of meeting of the Board of Directors. *(4 Marks)*

Answer

(a) The Council of the Institute of Chartered Accountants has issued guidelines for posting the particulars on Website by Chartered Accountants in practice and firms of Chartered Accountants in practice under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949. According to the guidelines the details in the website should be so designed that it does not amount to soliciting client or professional work. It is permitted to … is not permitted. PQR and Associates letterhead invites to people to visit their website. Similarly the website mentions the nature of assignments, names of the prominent clients and fees charged. The nature of assignments is permitted for display only on specific 'Pull" request. And the name of clients, the fees charged is not permitted at all.

PQR & Associates will be held guilty of Professional Misconduct under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949.

(b) Clause 11 of Part 1 of First Schedule to the Chartered Accountants Act, 1949 prohibits a member to engage in any business or occupation other than the profession of chartered accountants unless permitted by the Council so to engage. It does not prohibit a Chartered Accountant from being a director of a company, except managing director or a whole time director. But if any of the partners is interested in such company as an auditor then he cannot be director of the said company. In the present case Mr. B has accepted the directorship in a Company where his partner Mr. C is an auditor without obtaining specific permission of the council. Hence, Mr. B will be held for Professional Misconduct under Clause 11 of Part 1 of First Schedule to the Chartered Accountants Act, 1949.

Further, the Council of the Institute of Chartered Accountants of India has categorically stated that in cases where a member is a director of a company, the firm, in which the said member is a partner, should not express any opinion on its financial statements. Clause 4 of Part I of the Second Schedule to the Chartered Accountants Act, 1949 states that expressing an opinion on financial statement of any business establishment in which the auditor, his firm or a partner of his firm has a substantial interest would constitute misconduct unless he discloses the interest in his report. In cases, where a member of the Institute is a director of a company or a firm in which said member is a partner should not express any opinion on its financial statements. Hence Mr. C, a partner of Mr. B, should vacate the office.

(c) This is a case which is covered under the expression in other misconduct of the Chartered Accountants Act, 1949. Chartered Accountant is expected to maintain the highest standards and integrity even in his personal affairs and any deviation from these standards calls for disciplinary action. In the present case YKS & Co, being a concurrent auditor used his position to obtain the funds and failed to repay the same to the bank. This brings disrepute to the profession of a Chartered Accountant. This act of YKS & Co is not pardonable.

YKS & Co will be held guilty of other misconduct under section 22 of the Chartered Accountants Act, 1949.

(d) According to Clause 2 of Part 1 of Second Schedule to the Chartered Accountants Act, 1949 a chartered accountant is held guilty of professional misconduct if he certifies or submits a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or employee in his firm or any other chartered accountant in practice.

Mr. Mohan has issued a' certificate of consumption which does not reflect the correct factual position of the consumption of raw material by the concerned entity. He has failed in his duty of examining the record. He has relied on the minutes of Board of director's

 ...l. The

relevant record of production and stock register should have been scrutinized thoroughly and properly.

Clause 7 of Part 1 of Second Schedule to the Chartered Accountants Act, 1949 also applies to this case which states that a Chartered Accountant in practice shall be 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.

Mr. Mohan will be held guilty of Professional Misconduct under Clause 2 of Part 1 of Second Schedule to the Chartered Accountants Act, 1949.

Question 3

(a) *XYZ Ltd. appoints you as the auditor of the company. You observe that previous auditors A & Co., resigned. Also Balance Sheet as at 31-03-2010 shows an audit fee payable of ₹ 25,000. What precautions you will take before commencing the audit work? (4 Marks)*

(b) *While doing audit, Ram, the Auditor requires reports from experts for the purpose of Audit evidence. What types of reports/opinions he can obtain and to what extent he can rely upon the same? (4 Marks)*

(c) *Different types of controls which operate over date moving into, through and out of the computer. Auditor is required to review such control. Comment. (8 Marks)*

Answer

(a) Precautions before Commencing the Audit Work

In the instant case the auditor before accepting the appointment as well as commencing the audit work, the auditor should see the following:

1. When a previous auditor resigned the auditor should verify that the resolution appointing him as the auditor at the general meeting was duly moved and approved by the shareholders.

2. The auditor should refer to the resignation submitted by the previous auditor.

3. The auditor should communicate with him so as to ascertain.

   (i) The circumstances which led up to his resignation.

   (ii) Whether there existed any circumstances on account of which he should not accept the appointment.

   (iii) Whether the requirements of section 224(6) in respect of such an appointment have been complied with.

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

(b) Using the Work of an Expert

As per SA 620, "Using the Work of an Expert", during the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert.

While doing audit, Ram, the auditor can obtain the following types of reports, or options or statements of an expert for the purpose of audit evidence:

- Valuations of certain types of assets, for example, land and buildings, plant and machinery, works of art, and precious stones.
- Determination of quantities or physical condition of assets, for example, minerals stored in stockpiles, mineral and petroleum reserves, and the remaining useful life of plant and machinery.
- Determination of amounts using specialised techniques or methods, for example, an actuarial valuation.
- The measurement of work completed and to be completed on contracts in progress for the purpose of revenue recognition.
- Legal opinions concerning interpretations of agreements, statutes, regulations, notifications, circulars, etc.

When the auditor intends to use the work of an expert, he should seek reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial information, by considering the sufficiency, relevance and reliability of source data used, the assumptions and methods used and, if appropriate, their consistency with the prior period, and the results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of his audit procedures.

Standard on Auditing (SA) 200, "Basic Principles Governing an Audit", also states that when the auditor uses work performed by experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied.

(c) The review process for controls in a computerized information system (CIS) environment.

In a CIS environment there are different types of control which operate over data moving into, through and out of the computer. These are designed in such a way that the correct, complete and reliable processing and storage is ensured. It is necessary for the auditor to review such controls in order to get the correct result form the date entered. The review process can be laid down as follows:

(1) Organisation structure and control: The entity may have different functions under the CIS environment. There will be Date Administrator who will formulate data policies, plans the evaluation of the corporate data bases and maintain the data ... ational

efficiency of the database, the system Analyst will manage the information requirements for new and existing applications, and designs the information system, the System programmer will maintain and enhance the Operating system software, application programmer will design the Programme to meet the information requirement, Operation Specialist plans and control day-to-day operations, monitors and improves operational efficiency along with capacity planning and Librarian maintains library of magnetic media and documentation. The auditor will see that the responsibilities of each job position are clear and that the person understands the duties, authority and responsibilities. The duties have to be separated to ensure the internal control is established.

(2) Documentation Control: The auditor has to see that there is proper and adequate documentation for approval of system flowcharts Programme flowcharts, Programme changes, operator's instructions and programme description and the changes made in the above are also documented and approved by the authorized persons.

(3) Access Control: The auditor has to ensure the system prevents the persons who are authorized for access from accessing restricted data and programme and also prevents unauthorized persons gaining access to the system as a whole.

(4) Input controls: The control in respect of input has to be effective to ensure that only properly authorized and approved data goes in the input into the CIS system. For validation of input controls the auditor can apply some procedures like Check digit control, completeness totals control, reasonableness checks, field checks, record checks, file checks etc.

(5) Processing controls: These controls are must for integrity of data. Processing validation checks should be applied.

(6) Recording Controls: This is for enabling the records to be kept free of errors.

(7) Storage Controls: The data is the heart of the CIS system. Back up and recovery facilities will ensure the proper data availability to the management.

(8) Output controls: The data processed must go to the authorized person in the manner it is required and for this purpose input controls are maintained. The auditor is interested to know whether the audit trail relating to output is provided.

Question 4

(a) Mr. Ram, a relative of a Director was appointed as an auditor of the company. Comment.

(6 Marks)

(b) Mr. X, Director of ABC Ltd. made a purchase contract for ₹ 10,00,000 with the company. Comment. *(5 Marks)*

(c) PQR Ltd., a listed company and having an average annual turnover of more than ₹ 5 crores has no Internal Audit System. Give your views. *(5 Marks)*

Answer

(a) Appointment of the Auditor

Section 226 of the Companies Act 1956 deals with the qualification of Company auditors. According to that section there is no bar or prohibition on a relative of a director or partner of such relative to be appointed as auditor. Section 226 of the companies act specifically prohibits a member from auditing the accounts of a company in which he is a director or in the employment of an officer or an employee of the Company.

The provisions of the aforesaid section are not specifically applicable to the member who is relative of a director. According to the code of ethics there is no direct restriction on a member to accept the audit of a company where his relative is director. According to Clause 4 of Part 1 of Second Schedule of Chartered Accountants Act,1949 there is professional misconduct if the member expresses his opinion on financial statements of any business or enterprise in which he, his firm or a partner in his firm has a substantial interest. Here also there is no mention of relative. But this clause has been inserted for the purpose of ensuring the independence of the auditor so that his opinion on the financial statements is an independent opinion free of any interest.

In August 2008 the council has issued a guideline in this respect. As per that guideline a member of the institute shall desist from expressing his opinion on financial statements of any business or enterprise in which one or more persons, who are relatives within the meaning of section 6 of the Companies Act, 1956, have either by way of themselves or in conjunction with such members, a substantial interest in the said business or enterprise. Therefore if the director has substantial interest in the company then his relative should not accept the appointment of auditor of that company.

Before the amendment of the Chartered Accountants Act in the year 2006 there was no such restriction and the relative was able to express his opinion on the financial statements of the business entity provided he disclosed his interest in his report. The wording "provided he disclosed his interest" have been removed in the Chartered Accountants (Amendment) Act 2006 and the council has come out with the guidelines and the member has to desist from undertaking the audit of financial statement of the enterprise where his relative has substantial Interest. Substantial interest has also been defined by the council as sharing of more than 20% profits of the enterprise or holding shares having more than 20% of the voting power at any time during the relevant year.

In the instant case Mr. Ram, a relative of a Director, should not accept the appointment of auditor of that company.

(b) Responsibility of Auditor in relation to the Companies Act 1956.

As per Paragraph 4(v) (b) of CARO, 2003 the auditor has to comment "whether transactions made in pursuance of such contracts or arrangements have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time. Further, this information is required only in case of transactions exceeding the value of five lakh rupees in respect of any party and in any one financial year."

The contracts or arrangements covered above are those for which the register(s) are
uditor's

inquiry under this clause is restricted to such transactions referred to in sections 297 and 299 of the Act.

The auditor should, while reporting on this clause of the Order, in the first instance, determine whether the aggregate value of all the transactions entered into with any of the companies/firms/parties covered in the register maintained under section 301 of the Act exceed the value of rupees five lakhs. If so, the auditor has to examine whether each of the transactions entered into with such a company/firm/party have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time. Further, the auditor while reporting under this clause above should clearly bring out the reasons as to why no adverse comment was considered necessary.

The contracts refereed to in section 297 are for sale, purchase or supply of any goods, materials or services and contract of underwriting the subscription of any shares or debentures of the company between a Company and its director or, its relative, a firm in which the director or relative is a partner, any other partner in such a firm or a private company of which the director is a member or director.. The auditor will have to obtain the list of such parties which are covered by section 297 mentioned above.

Hence, the auditor should ensure that all the above provisions have been compiled with.

(c) Internal Audit System end CARO 2003.

The Companies Act, 1956 does not require a company to necessarily have an internal audit system. As per Para 4(vii) of CARO, 2003, statutory auditor is required to comment on whether the auditee company has an internal audit system commensurate with its size and nature of its business.

The clause has a mandatory application in respect of listed companies irrespective of the size of paid-up capital and reserves or turnover. For other companies, it is applicable if either of the following conditions is satisfied:

(a) The company has a paid-up capital and reserves exceeding ₹ 50 lakhs at the commencement of the financial year, or

(b) The company has an average annual turnover of ₹ 5 crores or more for a period of 3 consecutive financial years immediately preceding the financial year concerned.

In the instant case, PQR Ltd is a listed company and having an average annual turnover of more than ₹ 5 crores. Hence, the auditor will have to mention in his report the fact of not having such internal audit system by the Company.

Question 5

(a) "Examination of overdue debts, audit classification of society, and reporting the infringement of provisions of the Act are the special features of audit of a co-operative society." Do you agree? *(6 Marks)*

(b) Mr. R, the Tax Auditor finds that some payments inadmissible under Section 40 A(3) were made, and advised the client to report the same in form 3CD. The client contends

that cash payments were made since the other parties insisted upon the same and did not have Bank Accounts. Comment. *(5 Marks)*

(c) *Your client is contemplating taking over a manufacturing concern and desires that in the course of due diligence review, you should specifically look for hidden liabilities and over valued assets, if any. State in brief the major areas you would examine for the above.*

(5 Marks)

Answer

(a) Special Features of Co-operative Society Audit

The special features of co-operative society audit, to be borne in mind in general while conducting the audit are examination of overdue debts, overdue Interest, certification of bad debts, valuation of assets and liabilities ,adherence to co-operative principles, reporting infringement of act and rules, verification of members' register and examination of their pass books, special report to the registrar, audit classification of co-operative society, discussion of draft audit report with managing committee etc.

Besides the other special features mentioned above the Examination of overdue debts, audit classification of society and reporting the infringement of provisions of the Act, are some of special features of audit of a co-operative society which are explained as follows:

(1) Examination of overdue debts: Auditor of a co-operative society has to classify the overdue debts for a period from 6 months to five years and more than 5 years. Further these debts are to be analyzed in 'good' or 'bad' depending on the recoverability of the debts. The bad and doubtful debts require some provision and the auditor has to ascertain whether proper provision for bad & doubtful debts has been made. The current year's amount of overdue debts and its ratio to the working capital and loans outstanding is to be compared with last year to know whether the trend is increasing or decreasing. The status of the court cases for recovery of the overdue debts is also to be mentioned in the audit report. While calculating the profit the interest on the overdue debts is not to be taken into account. The Bad debts portion of the overdue debts is to be certified by the auditor for the purpose of writing off.

(2) Audit Classification of Co-operative Society: It is a unique feature of the Co-operative audit. After completion of the audit the auditor has to evaluate the working of the society on the basis of various parameters and criteria which are specified by the Registrar. It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification. The auditor should be very careful, while making a decision about the class of society.–For good performance having certain marks "A class is given. The D class is given to the society which shows very poor performance. In the same way B or C class is awarded on the basis of the marks obtained by the society.

(3) Reporting infringement of Act and Rules: The auditor of the co-operative Society is required to report the non compliance of the various provisions of the Co-
ociety.

He has to assess the financial implications of such infringements and disclose the same in his report. The infringements of serious nature are to be reported separately and infringements which do not have financial implications and which have no serious effect on the working of the society or rights of the members may be reported separately.

Thus we can say that Examination of overdue debts, audit classification of society and reporting the infringement of provisions of the Act, are only some of special features of audit of a co-operative society.

(b) Form 3 CD

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

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

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

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

(c) Major areas to examine in course of Due Diligence Review

Due diligence is an all pervasive exercise to review all important aspects like financial, legal, commercial, etc. before taking any final decision in the matter. As far as any hidden liabilities or overvalued assets are concerned, this shall form part of such a review of Financial Statements. Normally, cases of hidden liabilities and overvalued assets are not apparent from books of accounts and financial statements. Review of financial statements does not involve examination from the view point of extraordinary items, analysis of significant deviations, etc.

However in order to investigate hidden liabilities the auditor should pay his attention to

- Any show cause notice which have not matured into demands but may be material and important.
- Contingent liabilities not shown in books.
- Letters of comfort given to banks and financial institutions.
- Company may have sold some subsidiaries/businesses and may have agreed to take over and indemnify all liabilities and contingent liabilities of the same prior to the date of transfer.
- Product and warranty liabilities, product returns & discounts, liquidated damages, etc.
- Tax liability under direct and indirect taxes.
- Long pending sales tax assessment.
- Cases of custom duty where only provisional assessment has been made and final assessment is yet to be completed.
- Agreement to buy back shares at a stated price.
- Future lease liabilities.
- Environmental problems and Claims against the company including third party claims.
- Unfunded retirement benefit of employees.
- Labour claims under negotiation when the labour wage agreement has already expired.

<u>Regularly Overvalued Assets</u>:

The auditor shall have to specifically examine the following areas:

- Uncollected /uncollectable receivables.
- Obsolete, slow and non-moving inventories and inventories valued above net realizable value, if any, and huge inventories of packing materials etc with name of company.
- Obsolete and unused plant and machinery and their spares.
- Assets value which have impaired due to sudden fall in market value.
- Assets shown in books above market value due to capitalization of expenditure/foreign exchange fluctuation or capitalization of revenue expenditure.
- Assets under litigation.
- Investment shown at cost whose market value is much lower.
- Investment carrying very low rate of return.
- Group Company balances under reconciliation etc.

- Infructuous project expenditure/deferred revenue expenditure etc.
- Intangibles of no value.

Question 6

(a) *While doing the audit, X, the Statutory Auditor of ABC Ltd. observes that certain loans and advances were made without proper securities, certain debtors and creditors were adjusted inter se, and personal expenses were charged to revenue. Comment.* *(6 Marks)*

(b) *XYZ, a manufacturing unit does not accept the recommendations for improvements made by the Operational Auditor. Suggest an alternative way to tackle the hostile management.* (5 Marks)

(c) *"Corporate accountability and civil and criminal penalties for white collar crimes."Comment on the major provisions of Sarbanes Oxley Act.* *(5 Marks)*

Answer

(a) Audit Report

Section 227 (1A) requires the auditor to make certain specific enquiries during the course of his audit. As a result of enquiries if the auditor is satisfied then there is no further duty to report on these matters. It is to be noted that the auditor is required to make only enquiries and not investigate into the matters specified in section 227 (1A). If he is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. It should however be noted that the auditor is required to make only enquiries on the matters specified in the sub-section and is not to investigate into the matters referred to therein.

As per Clause (a) of Section 227 (1A) requires the auditor to inquire: “Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members.”

If the auditor finds that the loans and advances have not been properly secured, he may enter an adverse comment in the report but cannot probably doubt the true view of the accounts by reference to this fact so long the loans and advances are properly described and presented in terms of Part I of Schedule VI to the Companies Act. Further the auditor to inquire whether or not the terms on which the loans or advances have been made are prejudicial to the interests of the company or its members. If it is, he should qualify his report.

If debtors and creditors are adjusted inter se this amounts to merely book entries then the auditor, as per clause (b) should enquire “whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company.”This proposition has got to be inquired into by reference to the effects of the book entries, unsupported by transactions, on the legitimate interests of the company. The auditor has to exercise his judgment based on certain objective standards”.

Regarding Personal Expenses Clause (e) of section 227 (1A) requires the auditor to

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charging to revenue of such personal expenses, either on the basis of the company's contractual obligations, or in accordance with accepted business practice, is perfectly normal and legitimate or does not call for any special comment by the auditor. Where, however, personal expenses not covered by contractual obligations or by accepted business practice are incurred by the company and charged to revenue account, it would be the duty of the auditor to report thereon. It suffices to say that if the auditor finds that personal expenses have been charged to revenue and if the amounts are material, he should qualify his report also.

In the instant case, Mr. X, the statutory auditor of ABC Ltd., needs to enquire in light of above provisions, as a result of the enquiries if he is satisfied then there is no further duty to report on these matters.

(b) Alternative way to tackle the hostile management

While conducting the operational audit the auditor has to come across many irregularities and areas where improvement can be made and therefore he gives his suggestions and recommendations.

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

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

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

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

(c) Major provisions of Sarbanes Oxley Act

The Sarbanes Oxley Act of 2002 established corporate accountability and civil and criminal penalties for white – collar crimes. This act also known as the Public Company Accounting Reform and Investor Protection Act of 2002 and commonly called SOX or Sarbox; is a United States federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom. These scandals resulted in a decline of public trust in accounting and reporting practices.

This Act provides regulatory bodies and courts to take various actions –civil and criminal proceedings in connection of misstatements amounting to accounting scandals and fraudulent financial reports, other frauds on securities matters, obstruction of justice and retaliating against corporate whistleblowers. The Act also enforce tougher civil and criminal penalties for fraud and accounting scandals, securities fraud and certain other forms of obstruction of justice. As per SOX protect employer against corporate whistle blowers (person who provide evidence of fraud in the company).

Some of the major provisions of Sarbanes-Oxley Act of 2002 are:

- Creation of the Public Company Accounting Oversight Board (PCAOB);
- A requirement that public companies evaluate and disclose the effectiveness of their internal controls as they relate to financial reporting, and that independent auditors for such companies "attest" (i.e., agree, or qualify) to such disclosure;
- Certification of financial reports by chief executive officers and chief financial officers;
- Auditor independence, including outright bans on certain types of work for audit clients and pre-certification by the company's Audit Committee of all other non-audit work;
- Ban on most personal loans to any executive officer or director;
- Accelerated reporting of insider trading;
- Prohibition on insider trades during pension fund blackout periods;
- Enhanced criminal and civil penalties for violations of securities law;
- A requirement that companies listed on stock exchanges have fully independent audit committees that oversee the relationship between the company and its auditor;
- Additional disclosure;
- Significantly longer maximum jail sentences and larger fines for corporate executives who knowingly and willfully misstate financial statements, although maximum sentences are largely irrelevant because judges generally follow the Federal Sentencing Guidelines in setting actual sentences;
- Employee protections allowing those corporate fraud whistleblowers who file complaints with OSHA within 90 days to win reinstatement, back pay and benefits, compensatory damages, and congressional page abatement orders, and reasonable attorney fees and costs.

Question 7

Write short notes on any of the four:

(a) Circuit filters.

(b) Reversal of Income under Bank Audit.

(c) Guidance note on Audit of Miscellaneous Expenditure (revised).

(d) *Verification of Outstanding Premium and Agents' Balances.*

(e) *Reconciliation of Cost and Financial Accounts.* *(5 ´ 4 = 20 Marks)*

Answer

(a) Circuit filters

Circuit filters are the price bands that set the upper and lower limit within which a stock can fluctuate on any particular day. A price band for a day is a function of previous trading day's closing. SEBI has directed the exchanges to apply circuit filters on scrips traded in Rolling Settlement if their price fluctuates more than 20% of the closing price of scrips on the previous day in any direction. However, feeling the threat of high settlement default in scrips forming part of sensex or in which derivatives and futures are available, because of these filters, SEBI has restricted the fluctuation to 10% instead of 20%.

Price bands restrict extreme price movements and thereby resist price manipulation. These protect investors from extreme fluctuations in a panic market created by rumours and short term fears.

(b) Reversal of Income

If any advance, including bills purchased and discounted, becomes Non-Performing Assets as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s).

(c) Guidance note on Audit of Miscellaneous Expenditure (revised)

This Guidance Note provides guidance on audit procedures to be applied while auditing miscellaneous expenditure. 'Miscellaneous expenditure' shown in the balance sheet of companies (or shown under this or some other appropriate heading in the balance sheet of other enterprises) embraces within its fold a variety of items of expenditure which are not entirely charged to income in the year in which they are incurred, but are carried forward in the balance sheet to be written-off in subsequent periods. Unless some benefit from the expenditure can reasonably be expected to be received in future and unless the amount of such benefit is reasonably determinable, there is no justification for carrying forward the expenditure for being written-off in subsequent periods. Also, the amount of expenditure to be carried forward should not exceed the expected future revenue/other benefits related to the expenditure.

The Guidance Note deals with the audit considerations related to the following items that

(a) preliminary expenses;

(b) expenses including commission or brokerage on underwriting or subscription of shares or debentures including discount allowed on the issue of shares or debentures;

(c) research and development expenditure, etc.

Since AS 26, applies to different entity from different dates, it may happen that certain enterprises, till the date the standard becomes mandatory for them may continue to defer the expenditure incurred on items that normally constitute "miscellaneous expenditure". Once an entity applies AS 26 to account for intangible assets, the expenditure incurred on items that normally constitute miscellaneous expenditure shall be governed by the Standard, except in the case of already appearing miscellaneous expenditure in the balance sheet which is to be accounted for using AS 26.

As per Guidance note on Audit of Miscellaneous Expenditure (Revised), the auditor should examine whether the financial statements contain adequate disclosures as required by AS 26. The auditor should also examine that the financial statements disclose the accounting policy with regard to miscellaneous expenditure. On the first occasion when AS 26 is applied by an enterprise for accounting for items of miscellaneous expenditure, the financial statements should also disclose the change in accounting policy with regard to miscellaneous expenditure in accordance with the requirements of Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies".

(d) Verification of Outstanding Premium and Agents' Balances.

The following are the audit procedures to be followed for verification of outstanding premium and agents' balances:

(i) Scrutinise and review control account debit balances and their nature should be enquired into.

(ii) Examine inoperative balances and treatment given for old balances with reference to company rules.

(iii) Enquire into the reasons for retaining 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

(e) Reconciliation of Cost and Financial Accounts.

The cost records should be reconciled (preferably periodically) with the financial books of account so as to ensure accuracy. Variations, if any, should be clearly indicated and explained. The period for which such reconciliation be effected should not exceed the period of the financial year of the company. The reconciliation should be done in such a manner that profitability of the product under reference can be correctly adjudged and reconciled with the overall profits of the company. A statement showing the total expenses incurred by the company, including expenses excluded from the costing records and expenses on products not covered by the relevant Cost Accounting Records Rules, should be prepared and the share of the product covered by the Rules in such expenses should be indicated. Also the sale realisation of the products should be shown separately for products covered by the Rules and products not so covered and the margin representing the difference between respective sales realisation and the corresponding total cost should be determined. This statement in turn should be reconciled with the financial profit and loss account for the period. It may be mentioned that where a system of integrated cost and financial accounting is in operation, this reconciliation will be facilitated to a large extent. In this connection it may be noted that Schedule VI to the Companies Act requires the companies to give considerable amount of information regarding licensed capacity, installed capacity, actual production, consumption of raw material, etc. It should be ensured that the specific information required to be contained in both the costing and financial statements is not different. If at all any difference arises, the same should be properly reconciled and kept on record for reference.