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PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

Question No. 1 is compulsory

Answer any five from the rest

Question 1

As a statutory auditor of a company, comment on the following:

- (a) *A fire broke out on 15th May, 2012, in which material worth ₹ 50 lakhs which was lying in stock since 1st March, 2012 was totally destroyed. The financial statements of the company have not been adopted till the date of fire. The management of the company argues that since the loss occurred in the year, 2012-13, no provision for the loss needs to be made in the financial statements for 2011-12. (5 Marks)*
- (b) *While verifying the employee records in a company, it was found that a major portion of the labour employed was child labour. On questioning the management, the auditor was told that it was outside his scope of the financial audit to look into the compliance with other laws. (5 Marks)*
- (c) *For the year ended 31st March, 2012, the financial statements of A Pvt. Ltd. were adopted on 31st July, 2012. At this meeting, the directors proposed a dividend for the year 2011-12 of 25% on the equity share capital amounting to ₹ 10 lakhs. No entry was passed for the proposed dividend in the books of the company, since in the view of the directors the same was not required as per Revised Schedule VI. (5 Marks)*
- (d) *The accounting policy on Revenue Recognition for a company engaged in manufacture and sale of chemical products was stated as "Revenue is recognized only when it can be reliably measured and it is reasonable to expect ultimate collection". (5 Marks)*

Answer

- (a) **Event occurring after the balance sheet date:** This case requires attention to SA 560 "Subsequent Events" and AS 4 "Contingencies and Events occurring after the Balance Sheet Date".

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 or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.

AS – 4 also requires disclosure of the non-adjusting event, in the report of the approving authority.

Further, 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

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financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

The event took place after the close of the accounting year and does not relate to conditions existing at the balance sheet date. Thus, it will have no effect on items appearing at the balance sheet date because as per AS – 4 "Contingencies and Events Occurring after Balance Sheet Date" have to be adjusted that provide evidence of conditions existing as at the balance sheet date. However, the auditor has to ensure that this loss will not materially affect the substratum of the enterprises as per its size, nature and complexity of operations.

Thus, subject to satisfaction in respect of non-violation of going concern concept, the company has correctly accounted by not providing provision. However, the auditor is required to ensure the proper disclosure of abovementioned event.

- (b) **Compliance with Other Laws:** As per SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", the auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements including tax and labour laws.

Further, non-compliance with other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements.

In the instant case, major portion of the labour employed in the company was child labour. While questioning by auditor, reply of the management that it was outside his scope of financial audit to look into the compliance with other laws is not acceptable as it may have a material effect on financial statements.

Thus, auditor should ensure the disclosure of above fact and provision for the cost of fines, litigation or other consequences for the entity. In case if the auditor concludes that non-compliance has a material effect on the financial statements and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statement.

- (c) **Provision for Proposed Dividend:** The Revised Schedule VI requires disclosure of the amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share to be disclosed separately. It also requires separate disclosure of the arrears of fixed cumulative dividends on preference shares. The Old Schedule VI specifically required proposed dividend to be disclosed under the head "Provisions." In the Revised Schedule VI, this needs to be disclosed in the notes. Hence, a question that arises is as to whether this means that proposed dividend is not required to be provided for when applying the Revised Schedule VI.

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Further, as per AS-4 "Contingencies and Events Occurring After the Balance Sheet Date", there are events which, although take place after the balance sheet date are sometimes reflected in the financial statement because of Statutory requirement or because of their special nature and such item includes the amount of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered in the financial statements.

Keeping this in view and the fact that earlier the disclosure of provision for proposed dividend was statutory requirement as per Old Schedule VI, hence it was adjusting event as per AS 4 and was provided for. However, this statutory requirement has been changed to disclosure by way of notes as per Revised Schedule VI. Therefore, provision for proposed dividend is non-adjusting event.

In the instant case, director of A Pvt. Ltd. proposed the dividend on equity share capital @ 25%, for which no entry has been passed in the books of the company. Contention of the directors for non provision as per Revised Schedule VI is correct as statutory compliance has been changed.

Therefore, amount of proposed dividend should be disclosed by means of a note in the accounts.

(d) **Revenue Recognition:** As per AS 9 Revenue Recognition, in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

- (i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and
- (ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

Therefore, revenue from sales transactions should be recognised when the requirements as to performance set out above is satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim uncertainty regarding collection exist, then revenue recognition should be postponed.

In the instant case, the company is engaged in manufacturing and sale of chemical products, and made disclosure in accounting policy on recognition of revenue as per AS 1 stating that revenue is recognized only when it can be reliably measured and it is reasonable to expect ultimate collection, is correct. However, accounting policy disclosed above should also cover the aspect of transfer of risk and reward for the purpose of revenue recognition.

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Question 2

Give your comments with reference to the Companies Act, 1956 and the Chartered Accountants Act, 1949 and Schedules thereto:

- (a) A Chartered Accountant who was in practices since last 20 years died in a road accident. His widow sold the practice to another Chartered Accountant in practice for ₹ 30 lakhs. The price also included the right to use the firm name. (4 Marks)
- (b) K, Chartered Accountant in practice as a sole proprietor at Chennai has an office in the suburbs of Chennai. Due to increase in the income tax assessment work, he opens another office near the income tax office. For running the new office, he has employed a retired income Tax Commissioner. (4 Marks)
- (c) Mr. A has been appointed statutory auditor of a private limited company where his spouses' sisters' husband is having 75% ownership. (4 Marks)
- (d) Mr. E, proprietor of M/s. E & Co. is the statutory auditor of a Company which owns a store dealing in computer equipments. During the year 2011-12, E purchased a computer from the store costing ₹ 25,000 for his son. He did not make any payment for the same, but asked the company to adjust the same against the audit fees payable of ₹ 50,000. (4 Marks)

Answer

- (a) **Sale of Goodwill:** With reference to Clause (2) of Part I to the First Schedule to Chartered Accountants Act, 1949 the Council of the Institute of Chartered Accountants of India had an occasion to consider whether the goodwill of a proprietary concern of chartered accountant can be sold to another member who is otherwise eligible, after the death of the proprietor.

The Council resolved that the sale/transfer of goodwill in the case of a proprietary firm of chartered accountant to another eligible member of the Institute shall be permitted. It further laid down that in cases where the death of proprietor occurs after 30/8/1998, the goodwill of the deceased member's practice can be sold to another member and permission of the Institute has to be obtained within a year of the death of the proprietor concerned. It is even laid down that in such cases the name of the proprietary firm concerned would not be removed up to a period of one year from the death of the proprietor.

Thus, in the instant case, when the widow of the chartered accountant sold the practice to another member, it is nothing but goodwill sold to another member. The sale of the practice and the right to use the name is also allowed in terms of the above decision of the Council. Therefore, the above act of the widow of the Chartered Accountant is permissible.

- (b) **Maintenance of Branch Office in the same city:** As per section 27 of the Chartered Accountants Act, 1949 if a chartered accountant in practice has more than one office in

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India, each one of these offices should be in the separate charge of a member of the Institute. However, a member can be in charge of two offices if the second office is located in the same premises or in the same city, in which the first office is located; or the second office is located within a distance of 50 Kms from the municipal limits of a city, in which the first office is located.

In the given case, Mr. K, Chartered Accountant in practice as a sole proprietor at Chennai has an office in suburbs of Chennai, and due to increase in the work he opened another branch near the income tax office. He also employed the income tax commissioner to run the new office.

Assuming that the second office is situated within a distance of 50 Kms from municipal limits, there will be no misconduct if Mr. K will be in charge of both the offices, however, he will be liable to declare which of the two offices is the main office.

Note : Alternative view is possible on the assumption that distance of both the office is more than 50 Km, Hence, Mr. K will be liable for misconduct under section 27 of the Chartered Accountant Act, 1949.

- (c) **Appointment of Auditor in case of substantial interest:** Clause (4) of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that if an auditor expresses his opinion on the financial statements of any business or enterprises in which he, his firm or a partner in his firm or his relative has substantial interest, he is committing professional misconduct unless he discloses the interest in his report. Such disclosure is intended to assure the public as regard the faith and confidence that could be reposed in the independent opinion expressed by the auditor.

Further as per Council General Guidelines, 2008 the term relative shall have the same meaning as defined in AS 18 and spouses' sister' husband does not fall within this definition.

In the given case Mr. A, has been appointed as statutory auditor of a private limited company where his spouses' sisters' husband is having 75 % ownership i. e. substantial interest. As per AS 18, spouses' sisters' husband is not covered in the definition of the term relative.

Therefore, appointment of Mr. A as statutory auditor in such company would not amount to professional misconduct as per clause (4) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

- (d) **Independence of Auditor:** The guidance note on "Independence of Auditors" issued by the ICAI in this context recommends that "a question of indebtedness may also be raised where an auditor of a company purchases goods or services from the company audited by him. In such a case, if the amount outstanding exceeds ₹ 1000, irrespective of the nature of the purchase or period of credit allowed to other customers, the provisions concerning disqualification of auditor as contained in sec 226 (3) of the Companies Act, 1956 will be attracted."

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This is applicable in the case of purchase of Computer for his son or for personal work by the auditor of a company on normal terms and conditions of the business of the company as the amount outstanding at the end of the year exceeded ₹ 1000.

In the instant case, Mr. E, Proprietor of M/s E & Co. is the statutory auditor of a company which owns a store dealing in computer equipments, purchased a computer from the store and adjusted the payment for the same against his audit fee.

Therefore, the contention of Mr. E that he does not incur disqualification is not correct as he has purchased a computer of the value of ₹ 25,000 and asked the company to adjust the same against the audit fees payable of ₹ 50,000. Thus, Mr. E was disqualified under Section 226(3) of the Companies Act, 1956 to be appointed as auditor of the Company.

Hence, he would be deemed to have vacated his office as auditor but inspite of that he acted as the auditor of the company. Thus, Mr. E will be held liable for guilty of professional misconduct.

Question 3

Comment on the following:

- (a) *While carrying out the statutory audit of a large entity, what are the substantive procedures to be performed to assess the risk of material misstatement? (8 Marks)*
- (b) *M/s. PQR has been appointed the sole statutory auditor of a large company for 2011-12, where till last year M/s. LMN was also one of the joint auditors along with M/s. PQR. Mention the steps that should be taken by M/s. PQR before commencing the audit.*

(8 Marks)

Answer

- (a) **Substantive Procedures to be performed to assess the risk of material misstatement:** As per SA 330, "The Auditor's Response to Assessed Risk", substantive procedure is an audit procedure designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures.

Test of Details : The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size.

Substantive Analytical Procedure : Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that

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relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

Alternative Solution: SA 330 'The Auditor's Responses to Assessed Risks' requires the auditor to design and perform substantive procedures for each material class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement.

This requirement reflects the facts that:

- The auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and;
- There are inherent limitations to internal control, including management override.

Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient to reduce the audit risk to an acceptably low level;
- Only tests of detail are appropriate;
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

Based on the above, the auditor's substantive procedures would include the following audit procedures related to the financial statement closing process:

- Agreeing or reconciling the financial statements with the underlying accounting records and
- Examining material journal entries and other adjustments made during the course of preparing the financial statements.

- (b) **Steps before Commencing the Audit Work:** When one of the joint auditors of the previous year is appointed as the sole auditor for the next year, it is similar to new re-appointment of one of the retiring joint auditors. The provisions of section 225 of the

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Companies Act, 1956, relating to non-reappointment of the other person also need to be considered.

The following steps should be taken care of by M/s. PQR before commencing the audit:

- (i) Special notice under section 225(1) was duly received by the company from a member at least 14 days before AGM containing a proposal for appointing a sole auditor expressly.
- (ii) Verify notice sent to all the members at least 7 days before the AGM. [Under section 190(2)]
- (iii) Verify that special notice has been sent to retiring auditor forthwith. [Under section 225(2)]
- (iv) Any representation received from the retiring auditor was sent to the members [under section 225(3)].
- (v) Verify from the minutes whether the representation received from the retiring joint auditor was considered at the AGM.
- (vi) Examine that proposed resolution was properly passed.
- (vii) Ensure that provisions of section 224(2) are complied fully.
- (viii) Ascertain special resolution under section 224A, if any, is passed accordingly.
- (ix) Obtain a certified copy of the relevant minutes of AGM and a written communication of the appointment within 7 days.

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.

Question 4

Answer the following:

- (a) What are the considerations which an auditor should consider while evaluating the reliability of the accounting and internal control systems in a CIS environment? (8 Marks)
- (b) Under the applicable Standards on Auditing, in what circumstances does the report of the as a statutory auditor require modifications? What are the types of modifications possible to the said report? (8 Marks)

Answer

- (a) While evaluating the reliability of the accounting and internal control systems, the auditor would consider whether these systems:
 - (i) Ensure that authorized, correct and complete data is made available for processing;

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- (ii) Provide for timely detection and correction of errors.
 - (iii) Have Data recovery arrangement and Back-up system in place at all times.
 - (iv) Ensure that the case of interruption in the work of the CIS environment due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records;
 - (v) Ensure the accuracy and completeness of output;
 - (vi) Provide adequate data security against fire and other calamities, wrong processing, frauds etc,
 - (vii) Prevent unauthorized amendments to the program;
 - (viii) Provide for safe custody of source code of application software and data files.
- (b) **Modifications in Audit Report:** As per SA 700, "Forming an Opinion and Reporting on Financial Statements", the auditor may modify the opinion in the auditor's report in the following circumstances:
- (i) If the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
 - (ii) If the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with SA 705.

Types of Modification to the Auditor's Opinion: As per SA 705, "Modification to the Opinion in the Independent Auditor's Report", modified opinion may be defined as a qualified opinion, an adverse opinion or a disclaimer of opinion.

Types of modifications possible to the said report are below-mentioned:

- (1) **Qualified Opinion** : The auditor shall express a qualified opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.
- (2) **Adverse Opinion**: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

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- (3) **Disclaimer of Opinion:** The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

Question 5

Answer the following:

- (a) Under CARO, 2003, how, as a statutory auditor would you comment on the following:
- (i) X Pvt. Ltd. is a subsidiary of a listed entity incorporated outside India. The management of the company believes that since, X Pvt. Ltd. is a Private Company and satisfies all condition under the Companies (Auditor's Report) Order, 2003, reporting under CARO is not applicable.
- (ii) A term loan was obtained from a bank for ₹ 50 lakhs for the purpose of purchase of assets for Research & Development (R & D). Out of these funds, a vehicle was purchased for the use of the concerned director who was in charge of the R & D activities. (8 Marks)
- (b) As an auditor how will you verify the existence of Related Parties? (8 Marks)

Answer

- (a) (i) **Applicability of CARO 2003 :** The Companies (Auditor's Report) Order (CARO), 2003 applies to all the companies including foreign companies as defined in the Companies Act, 1956, except certain categories of companies specifically exempted from the application of the order.

The Companies (Auditor's Report) Order (CARO), 2003, exempts private limited companies from its application which fulfils all the following conditions:

- (1) its paid-up capital and reserves are rupees fifty lakh or less;
- (2) its outstanding loan from any bank or financial institution are rupees twenty five lakh or less; and
- (3) its turnover does not exceed rupees five crore.

In the instant case M/s X Pvt. Ltd. is a subsidiary of a listed entity incorporated outside India and on the basis of contention of the management that it is a private limited company which satisfies all the above mentioned conditions as per CARO 2003.

As a statutory auditor after ensuring the fulfillment of all the above conditions cumulatively, the contention of the management is correct.

Thus, reporting under CARO, 2003 will not be applicable for X Pvt. Ltd. Company.

- (ii) **Utilisation of Term Loans:** Under CARO, 2003, an auditor is required to comment whether term loans were applied for the purpose for which the loans were obtained.

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The auditor should examine the terms and conditions of the term loan with the actual utilisation of the loans. If the auditor finds that the fund has not been utilized for the purpose for which they were obtained, the report should state the fact.

In the instant case, since term loan taken for the purpose of purchase of assets for Research & Development (R&D) has been utilized for purchase of vehicle for the use of Director which has no relation with assets for Research & Development (R & D). Therefore, vehicle though used for Director who was incharge of the R&D activities, cannot be considered as purchase of assets for Research & Development (R & D). The auditor should state the fact in his report that the out of term loan of R & D, a certain sum was not utilised for the purpose of acquiring the R & D assets.

(b) **Verification of Existence of Related Parties:** As per SA 550 "Related Parties", during the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.

- Entity income tax returns.
- Information supplied by the entity to regulatory authorities.
- Shareholder registers to identify the entity's principal shareholders.
- Statements of conflicts of interest from management and those charged with governance.
- Records of the entity's investments and those of its pension plans.
- Contracts and agreements with key management or those charged with governance.
- Significant contracts and agreements not in the entity's ordinary course of business.
- Specific invoices and correspondence from the entity's professional advisors.
- Life insurance policies acquired by the entity.
- Significant contracts re-negotiated by the entity during the period.
- Internal auditors' reports.
- Documents associated with the entity's filings with a securities regulator (e.g, prospectuses).

Arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions.

In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

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- (1) Bank, legal and third party confirmations obtained as part of the auditor's procedures;
- (2) Minutes of meetings of shareholders and of those charged with governance; and
- (3) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

Question 6

Answer the following:

- (a) *You have been appointed to investigate a suspected embezzlement of cash receipts in a departmental store. What are the steps you would take in this regard?* (6 Marks)
- (b) *As an auditor of a partnership firm under section 44AB of the Income Tax Act, 1961, how would you report on the following:* (4 Marks)
 - (i) *Capital expenditure incurred for scientific research assets*
 - (ii) *Expenditure incurred at clubs*
- (c) *As an auditor of a Non Banking Financial Company registered with the Reserve Bank of India (RBI), what are the prudential norms of RBI, whose compliance is to be verified?* (6 Marks)

Answer

- (a) **Investigation of suspected embezzlement of cash receipts:** While doing investigation of suspected embezzlement of cash receipts of a departmental store, we would like to take belowmentioned steps :
 - (i) Before proceeding to investigate a suspected embezzlement, the investigating accountant should ascertain the exact duties of the person concerned who is suspected to have committed a fraud; his relationship to the general routine of the office, and the circumstances in which any known instances of defalcation have come to light. Such an enquiry would give a clue to promising avenues of investigation. Greater the authority of the individual suspected of a fraud, wider would be the field which would have to be covered by the investigation.
 - (ii) He should also examine the line of responsibility between the various members of the staff.
 - (iii) He should have a look at the system of internal control in operation for spotting out the weaknesses, if any, that may exist in it. Relying on the above study, he should direct his enquiry towards those aspects of the business where there has been excessive control in the hands of single persons, without any supervision by any other person or any other inherent weakness that may be in existence in the system.

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- (iv) On the assumption that cash may have been diverted before being entered in the books, evidence as regards income received from different sources should be scrutinised, e.g., stock, sales summaries, rental registers, correspondence with customers, advices of travelling salesmen and counterfoils or receipts.
 - (v) Carbon copies of receipts marked 'duplicate', should be scrutinised to confirm that they are in fact copies of receipts issued earlier.
 - (vi) By recalling paying-in-slips from the bank the details of cash deposited on each day should be compared with those shown in the Cash Book.
 - (vii) The record of sales of scrap of waste paper, that of collection of rents from labourers temporarily accommodated in the company's quarters, that of refunds of amounts deposited with the electric supply co., and other Government authorities should be examined for finding out if any of these amounts have been misappropriated.
 - (viii) Cash sales should be vouched in detail. Recoveries from customers and sundry parties should be checked with the copies of receipts issued to them; deductions made on account of cash discounts should be reviewed.
 - (ix) All withdrawals from the bank should be checked by reference to corresponding entries in the bank pass book.
- (b) (i) **Capital Expenditure incurred for Scientific Research Assets** : Expenditure on Scientific Research (capital as well as revenue) covered under section 35 of the Income-tax Act, 1961, is to be reported by a tax auditor in clauses 15(a) and (b) of Form 3CD. The tax auditor is required to report amount (i) debited to the profit and loss account (showing the amount debited and deduction allowable as per clause 15 (a) and (ii) not debited to the profit and loss account as per clause 15 (b).
- Accordingly, the tax auditor should report under Clause 15(b) the amount of capital expenditure not debited to the Profit and Loss Account which is eligible for deduction under section 35 as Scientific Research Expenditure.
- (ii) **Payment to Club**: As per Clause 17(d) of Form 3 CD, the amount of payments made to clubs by the assessee during the year should be indicated.
- The payments may be for entrance fees as well as membership subscription and for catering and other services by the club, both in respect of directors and other employees in case of companies, and for partners or proprietors in other cases. The fact whether such expenses are incurred in the course of business or whether they are of personal nature should be ascertained. If they are personal in nature, they are to be shown separately under Clause 17(b).
- Hence the tax auditor has to report the payments to clubs under Clause 17(d) of Form 3CD.

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(c) Compliance of Prudential Norms by NBFC:

- (i) 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 against its own shares; (7) Prohibition on loans and investments for failure to repay public deposits and (8) Norms for concentration of credit etc.
- (ii) The auditor shall ensure that Board of the NBFC shall frame a policy for granting demand/call loans and implement the same.
- (iii) The auditor should verify the classification of advances and loans as standard / sub-standard / doubtful / loss and that proper provision has been made in accordance with the directions.
- (iv) Auditor should ensure that unrealised income from non-performing assets has not been taken to profit and Loss Account.
- (v) 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 any four of the following:

- (a) *Responsibility of holding company for preparation of Consolidated Financial Statements.*
- (b) *Areas of proprietary audit under section 227(1A) of the Companies Act, 1956.*
- (c) *Circuit filters/Circuit breakers.*
- (d) *Environmental Audit.*
- (e) *Supplementary audit under section 619(3) of the Companies Act, 1956. (4 × 4 = 16 Marks)*

Answer

- (a) Responsibility of Holding Company for preparation of Consolidated Financial Statements:** The responsibility for the preparation and presentation of consolidated financial statements, among other things, is that of the management of the parent/holding company. This includes:
- (i) identifying components, and including the financial information of the components to be included in the consolidated financial statements;
 - (ii) where appropriate, identifying reportable segments for segmental reporting;
 - (iii) identifying related parties and related party transactions for reporting;
 - (iv) obtaining accurate and complete financial information from components; and
 - (v) making appropriate consolidation adjustments.

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Apart from the above, the parent ordinarily issues instructions to the management of the component specifying the parent's requirements relating to financial information of the components to be included in the consolidated financial statements. The instructions ordinarily cover the accounting policies to be applied, statutory and other disclosure requirements applicable to the parent, including the identification of and reporting on reportable segments, and related parties and related party transactions, and a reporting timetable.

- (b) **Areas of propriety audit under section 227(1A)** : Section 227(1A) of the Companies Act, 1956 requires the auditor to make an enquiry into certain specific areas. In some of the areas, the auditor has to examine the same from propriety angle as to:
- (i) 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;
 - (ii) Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company;
 - (iii) Whether the company is not an investment of company within the meaning of section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
 - (iv) Whether loans and advances made by the company have been shown as deposits. Again, considering the propriety element, rationalizing the proper disclosure of loans and advance given by company is made;
 - (v) Whether personal expenses have been charged to revenue account;
 - (vi) In case it is stated in the books and papers of the company that shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash actually received, whether the position in books of account and balance sheet so stated is correct, regular and not misleading. A control has been set up to verify the receipt of cash in case of allotment of shares for cash. Further, if cash is not received, the books of accounts and statement of affairs shows the true picture.
- (c) **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.

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(v) This also protects investor from extreme fluctuations.

- (d) **Environmental Audit:** Environmental reporting deals with the disclosure by an entity of environmentally related data, regarding environmental risks, environmental impacts, policies, strategies, targets, costs, liabilities or environmental performance to those who have an interest in such information as an aid to enabling/enriching their relationship with the reporting entity via either the annual report; a stand-alone corporate environmental performance report; or some other medium (e.g. staff newsletter, video, CD ROM, internet site). The reports that are generated after such audits can be either compliance-based reporting or impact-based performance reporting.

Environmental audit deals with verification of information contained in such reports with a view to expressing an opinion thereon. Environmental audit can be performed by external agencies or internal experts (including internal auditors). In practice, environmental audit is not done by a single agency but by various agencies who are experts in the field. Since the subject matter of environmental audit involves multi-disciplinary knowledge and skill, it is preferable to form a team of persons drawn from different disciplines who may assist the chartered accountant in performing the task in an effective manner, generally environmental audits are not required by any statute but are sometimes done at the request of the management to address issues like compliance with environmental laws and regulations, etc.

- (e) **Supplementary Audit under section 619(3) of the Companies Act, 1956:** Section 619 (3) of the Companies Act, 1956 delegates the power to C&AG to conduct a supplementary or test audit of the company's accounts by such person or persons as he may authorise in this behalf. The person to be so authorized may well be the auditors appointed under sub-section (2) of that section.

Further C&AG may also direct by general or special order for any required information or additional information on such matter in such form by such person or persons, to be furnished to any authorised person or persons.

The Supplementary audit under section 619(3) requires the auditor to give additional reports on those areas specified by the C&AG and the same has to be submitted within a time frame after submission of the statutory audit report to the company.

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