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**PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS**

*Question No. 1 is compulsory*

*Answer any five from the rest*

**Question 1**

- (a) *X Limited, a newly incorporated company in India commenced its business from April 1, 2012. The Company purchased fixed assets costing ₹ 4,000 lakhs on 01-04-2012 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal installments. Exchange rates were 1 Dollar = ₹ 40.00 and ₹ 42.50 as on 01-04-2012 and 31-03-2013 respectively. The company worked out foreign exchange loss as per AS 11 at ₹ 250 Lakhs and expensed the entire amount in the profit and loss account. The Managing Director of the company was worried about this heavy revenue loss and asked the accountant not to follow AS 11 issued by the ICAI for this particular transaction. The Accountant of the company, followed the instruction of the Managing Director and removed exchange loss from the profit and loss account but then he added the entire exchange loss to the value of fixed asset and computed the depreciation thereon. As an Auditor of X Limited how you would deal with this particular transaction ?*

*(5 Marks)*

- (b) *G Ltd. is a mobile phone operating company. Barring the marketing function it had outsourced the entire operations like maintenance of mobile infrastructure, customer billing, payroll, accounting functions, etc. Assist the auditor of G Ltd. as to how he can obtain an understanding of how G Ltd. uses the services of the outsourced agency in its operations.*

*(5 Marks)*

- (c) *Beta Limited, is a company registered with SEBI, having five subsidiaries.*

*M/s XYZ, Chartered Accountants, have been appointed as Statutory Auditors for the audit of the Consolidated Financial Statements for the year ending March 31, 2013. Out of five subsidiaries, the audit of one subsidiary was conducted by another auditor, M/s Badnam and Company, Chartered Accountants. The "Opinion" para of audit report furnished by M/s XYZ Chartered Accountants is given below:*

**Opinion**

*In our opinion and to the best of our information and according to the explanations given to us the consolidated financial statements give a true and fair view, except the financial statement of one subsidiary whose accounts were audited by M/s Badnam and Company, Chartered Accountants and about the same we are not in a position to express our opinion as the audit has not been performed by us :*

- (i) *in the case of the consolidated Balance Sheet, of the state of affairs of the Company as at March 31, 2013.*

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(ii) *in the case of the consolidated Profit and Loss Account, of the profit/loss for the year ended on that date.*

*Do you find any deficiencies in the opinion para ? If yes, you are required to give your suggestions and redraft the opinion para. (5 Marks)*

- (d) *M/s Honest Limited has entered into a transaction on 5<sup>th</sup> March, 2013, near year-end, whereby it has agreed to pay ₹ 5 lakhs per month to Mr. Y as annual retainer-ship fee for "engineering consultation". No amount was actually paid, but ₹ 60 lakhs is provided in books of account as on March 31, 2013.*

*Your inquiry elicits a response that need-based consultation was obtained round the year, but there is no documentary or other evidence of receipt of the service. As the auditor of M/s Honest Limited, what would be your approach? (5 Marks)*

**Answer**

- (a) As per new para 46A(1) of AS 11 "The Effects of Changes in Foreign Exchange Rates" inserted by Ministry of Corporate Affairs by way of notification, the exchange differences arising on reporting of long- term foreign currency monetary items in so far as they relate to the acquisition of a depreciable capital asset in respect of accounting periods commencing on or after the 1st April, 2011. Such exchange differences can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, it can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long term asset or liability, by recognition as income or expense in each of such periods.

Thus, X Ltd. has the choice to avail this option. However, the company should disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized.

- (b) As per SA 402 on "Audit Considerations Relating to an Entity Using a Service Organisation", when obtaining an understanding of the user entity in accordance with SA 315, the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including:
- (i) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control;
  - (ii) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;
  - (iii) The degree of interaction between the activities of the service organisation and those of the user entity; and

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- (iv) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation.
- (c) Yes, the opinion para contains the following deficiencies.
1. Out of five subsidiaries, the audit of one subsidiary was conducted by another auditor, M/s Badnam and Company which would be reported in other matter para.
  2. After point no. (ii) in the opinion para, point no. (iii) would appear as under-  
"in the case of the consolidated Cash Flow Statement, of the cash flows for the year ended on that date."

The redrafted opinion para and other matter para are given hereunder as per SA 706 on Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report-

#### **Opinion Para**

In our opinion and to the best of our information and according to the explanations given to us and based on the consideration of the reports of the other auditors on the financial statements of the subsidiaries as noted below, the consolidated financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

- (a) in the case of the consolidated Balance Sheet, of the state of affairs of the Company as at March 31, 2013;
- (b) in the case of the consolidated Profit and Loss Account, of the profit/ loss for the year ended on that date; and
- (c) in the case of the consolidated Cash Flow Statement, of the cash flows for the year ended on that date.

#### **Other Matter Para**

We did not audit the financial statements of one subsidiary, whose financial statements reflect total assets (net) of ₹ XXXX as at March 31, 2013, total revenues of ₹ XXXX and net cash outflows amounting to ₹ XXXX for the year then ended. These financial statements have been audited by other auditors M/s Badnam and Company, Chartered Accountants whose reports have been furnished to us by the Management, and our opinion is based solely on the reports of the other auditors. Our opinion is not qualified in respect of this matter.

- (d) As per SA 240 on "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", fraud can be committed by management overriding controls using such techniques as Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.

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Keeping in view the above, it is clear that Company has passed fictitious journal entries near year end to manipulate the operating results. Also Auditor's enquiry elicited a response that need-based consultation was obtained round the year, but there is no documentary or other evidence of receipt of the service, is not acceptable.

Accordingly, the auditor would adopt the following approach-

If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

- (1) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
- (2) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and
- (3) If the auditor withdraws:
  - (i) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
  - (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

#### Question 2

- (a) *Mr. X who passed his CA examination of ICAI on 18<sup>th</sup> July, 2013 and started his practice from August 15, 2013. On 16<sup>th</sup> August 2013, one female candidate approached him for articleship. In addition to monthly stipend, Mr. X also offered her 1 % profits of his CA firm. She agreed to take both 1 % profits of the CA firm and stipend as per the rate prescribed by the ICAI. The Institute of Chartered Accountants of India sent a letter to Mr. X objecting the payment of 1 % profits. Mr. X replies to the ICAI stating that he is paying 1 % profits of his firm over and above the stipend to help the articled clerk as the financial position of the articled clerk is very weak. Is Mr. X Liable to professional misconduct ? (4 Marks)*
- (b) *Mr. Honest, a Chartered Accountant in practice, wrote two letters to M/s XY Chartered Accountants a firm of CAs; requesting them to allot him some professional work. As he did not have a significant practice or clients he also wrote a letter to M/s ABC, a firm of Chartered Accountants for securing professional work. Mr. Clever, an another CA, informed ICAI regarding Mr. Honest's approach to secure the professional work. Is Mr. Honest wrong in soliciting professional work? (4 Marks)*

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- (c) C & Co., hired Mr. A, Chartered Accountant, to compile its financial statements for the interim period ending on 31<sup>st</sup> December 2012. Kindly assist Mr. A in drafting scope of engagement letter with specific focus on C & Co's responsibility. (4 Marks)
- (d) Mr. X was appointed as the auditor of M/s Easygo Ltd. and intends to apply the concept of materiality for the financial statements as a whole. Please guide him as to the factors that may affect the identification of an appropriate benchmark for this purpose. (4 Marks)

**Answer**

- (a) As per Clause (2) of Part-1 of First Schedule of the Chartered Accountants act 1949, a Chartered Accountants in practice shall be deemed to be guilty of professional misconduct if he pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services to time in or outside India.

In view of the above, the objections of the Institute of Chartered Accountants of India are correct and reply of Mr. X, stating that he is paying 1 % profits of his firm over and above the stipend to help the articled clerk as the position of the articled clerk is weak is not tenable. Hence, Mr. X is liable to professional misconduct in terms of Clause (2) as explained above.

- (b) Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means. Provided that nothing herein contained shall be construed as preventing or prohibiting any Chartered Accountant from applying or requesting for or inviting or securing professional work from another chartered accountant in practice.

Such a restraint has been put so that the members maintain their independence of judgment and may be able to command respect from their prospective clients.

In the given case, Mr. Honest wrote letters only to other Chartered Accountants, M/s XY and M/s ABC requesting them to allot some professional work to him, which is not prohibited under clause (6) as explained above. Thus, Mr. Honest is not wrong in soliciting professional work.

- (c) The engagement letter to be issued by Mr. A should state the following as management's responsibility:
- (i) the accuracy and completeness of the information supplied to us, including maintenance of adequate accounting records and internal controls and selection and application of appropriate accounting policies.

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- (ii) preparation and presentation of the financial statements of the entity, in accordance with the applicable laws and regulations, if any.
  - (iii) safeguarding the assets of the entity and also establishing appropriate controls designed to prevent and detect fraud and other irregularities.
  - (iii) ensuring that the activities of the entity are carried in accordance with applicable laws and regulations and that it institutes appropriate controls to prevent and detect any non-compliance.
  - (iv) Ensuring complete disclosure of all material and relevant information to the accountant.
- (d) As per SA 320 on "Materiality in Planning and Performing an Audit", use of Benchmarks in Determining Materiality for the Financial Statements as a Whole

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- (i) The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- (ii) Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- (iii) The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- (iv) The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- (v) The relative volatility of the benchmark.

### Question 3

- (a) *Excellent Limited, a Company incorporated in India and listed with SEBI, has a scheme for payment of settlement allowance to retiring employees. Under the scheme, retiring employees are entitled to reimbursement of certain travel expenses for class they are entitled to as per company -les and regulations. Employees are also entitled to claim a lump-sum payment to cover expenses on food and stay during the travel. The Company also gives option to employees that they can claim a lump-sum amount equal to three months pay last drawn.*

*Excellent Limited have following accounting policies to record these travel expenses:*

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- (i) Settlement allowance does not depend upon the length of service of employee. It is restricted to employee's eligibility under the travel rule of the company therefore all travel expenses fall under the category of defined contribution plans.
- (ii) Since it is not related to the length of service of the employees, it is difficult to estimate reliably and there is no present obligation to pay employees as per AS 29 "Provisions, Contingent Liabilities and Contingent Assets", hence it is accounted for on claim basis.

You are statutory auditor of Excellent Limited. What would be your guidance to audit team ? (4 Marks)

- (b) Q Ltd. operates in an ERP environment. Its auditor requires your assistance on the aspects that are needed to be looked into in respect of control over input and output of transactions. Kindly help him. (4 Marks)
- (c) In the audit of Hotel Great Stay Ltd. its auditor wants to use the analytical procedure as substantive procedure in respect of room rental income as well as payroll costs. Guide him as to how it can be done. (4 Marks)
- (d) C.A. Prabhu, is a leading income tax practitioner and consultant for derivative products. He resides in Mumbai near to the ABC commodity stock exchange and does trading in commodity derivatives. Every day, he invests nearly 50% of his time to settle the commodity transactions. Is C.A. Prabhu liable for professional misconduct ? (4 Marks)

**Answer**

- (a) The present case falls under the category of defined benefit scheme under AS 15 "Employee Benefits". The said scheme encompasses cases where payment promised to be made to an employee at or near retirement presents significant difficulties in the determination of periodic charge to the statement of profit and loss. The contention of the Company that the settlement allowance will be accounted for on claim basis is not correct even if company's obligation under the scheme is uncertain and requires estimation. In estimating the obligation, assumptions may need to be made regarding future conditions and events, which are largely outside the company's control. Thus,
- (1) Settlement allowance payable by the company is a defined retirement benefit, covered by AS 15.
  - (2) A provision should be made every year in the accounts for the accruing liability on account of settlement allowance. The amount of provision should be calculated according to actuarial valuation.
  - (3) Where, however, the amount of provision so determined is not material, the company can follow some other method of accounting for settlement allowances.
- (b) **Control Over Input transactions** - Control are designed to provide reasonable assurance that:
- (1) transactions are properly authorised before being processed by the computer.

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- (2) transactions are accurately converted into machine readable form and recorded in the computer data files.
- (3) transaction are not lost, added, duplicated or improperly changed.
- (4) incorrect transactions are rejected, corrected and if necessary, resubmitted on a timely basis.

**Control Over Output transactions** - Designed to provide reasonable assurance that

- (1) results of processing are accurate.
  - (2) access to output is restricted to authorised personnel.
  - (3) output is provided to appropriate authorised personnel on a timely basis.
- (c) As per SA 520 on "Analytical Procedures", in some cases, even an unsophisticated predictive model may be effective as an analytical procedure.

In case of Payroll cost - 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.

In case of Room Rental Income of Hotel- Different types of analytical procedures provide different levels of assurance. Analytical procedures involving the prediction of total rental income in case of Hotel taking the room tariff rates, the number of rooms and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified.

- (d) As per clause 11 of Part-I of First Schedule of CA Act, 1949, a Chartered Accountant is deemed to be guilty of professional misconduct if he "engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage".

However, the Council has granted general permission to the members to engage in certain specific occupation. In respect of all other occupations specific permission of the Institute is necessary.

In this case CA Prabhu is engaged in the occupation of trading in commodity derivatives which is not covered under the general permission.

Hence specific permission of the Institute has to be obtained otherwise he will be deemed to be guilty of professional misconduct under clause 11 of Part-I of First Schedule of CA Act, 1949.

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**Question 4**

- (a) *H Limited, a company registered with SEBI, has three subsidiaries and one associate. While doing the audit of Consolidated Financial Statements (CFS) of H Limited you have come to know that the associate entity had made a provision for proposed dividend in its financial statements. H Limited computed its share of the results of operations of the associate after taking into account the proposed dividend. Comment. (4 Marks)*
- (b) *While doing the audit of a nationalized bank, your Audit Assistant informed you that there are a lot of irregularities in Telegraphic Transfers and Demand Drafts. What guidance would be give to the Audit Assistant? (4 Marks)*
- (c) *ABC Limited, an Indian insurance company carrying on general insurance business, is facing liquidity problems and, therefore, it has decided to maintain deposits under section 7 of the Insurance Act, 1938 at one percent of total gross premium written in India. The company thinks that it is sufficient, as the company has a Paid-up Capital of ₹ 150 Crores. As an Auditor of ABC Limited what would be your suggestion to the company for compliance of Insurance Act and rules and regulations made there under? (4 Marks)*
- (d) *The Auditor of S Limited has just commenced the statutory audit. What should be considerations for the effectiveness of a system of internal check? (4 Marks)*

**Answer**

- (a) As per AS 23 on "Accounting for Investments in Associates in Consolidated Financial Statements", adjustments to the carrying amount of investment in an investee arising from changes in the investee's equity that have not been included in the statement of profit and loss of the investee are directly made in the carrying amount of investment without routing it through the consolidated statement of profit and loss. The corresponding debit/credit is made in the relevant head of the equity interest in the consolidated balance sheet. For example, in case the adjustment arises because of revaluation of fixed assets by the investee, apart from adjusting the carrying amount of investment to the extent of proportionate share of the investor in the revalued amount, the corresponding amount of revaluation reserve is shown in the consolidated balance sheet.

In case an associate has made a provision for proposed dividend in its financial statements, the investor's share of the results of operations of the associate is computed without taking in to consideration the proposed dividend.

Applying the above provisions to the given problem, H Limited should have computed its share of the results of operations of the associate without taking into consideration the proposed dividend. Therefore, treatment made by H Ltd is not correct.

- (b) In respect of Telegraphic Transfers and Demand Drafts, the audit assistant would be given the following guidance-

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- (1) The bank should have a reliable private code known only to responsible officers of its branches, coding and decoding of telegrams should be done only by such officers.
  - (2) The signatures on a demand draft should be checked by an officer with the Signature Book.
  - (3) All the T.Ts and D.Ds. sold by a branch should be immediately confirmed by the advices to the branches concerned.
  - (4) If the paying branch does not receive proper confirmation of any T.T. or D.D. from the issuing branch or does not receive credit in its account with that branch, it should take immediate steps to ascertain the reasons.
- (c) Section 7 of the Insurance Act, 1938 requires every insurer, carrying a general insurance business, to deposit and keep deposited with RBI in it's one of the offices in India a sum equivalent to three percent of total gross premium written in India in any financial year. The maximum limit of deposit under this section is Rupees ten crores. The deposit is to be for and on behalf of the Government of India. The deposit can be made either by way of cash or investment in approved securities. If securities are deposited, their estimated market value on the date of deposit is to be seen. The amount of deposit required in the case of reinsurance business is rupees twenty crores.

In the given case, Since ABC Limited has decided to maintain deposits at one percent of the total gross premium written in India, which is violation of the Section 7 of the Insurance Act, 1938. The contention of the company that it has a paid up capital of ₹ 150 Crores would not make the difference.

- (d) **Considerations for the effectiveness of a System of Internal Check:** The term "internal check" is defined as the "checks on day to day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud". The following aspects should be considered in framing a system of internal check:
- (1) No single person should have an independent control over any important aspect of the business. The work done by one person should automatically be checked by another person in routine course.
  - (2) The duties/work of members of the staff should be changed from time to time without any previous notice so that the same officer or subordinate does not, without a break, perform the same function for a considerable length of time.
  - (3) Every member of the staff should be encouraged to go on leave at least once in a year so that frauds successfully concealed by such a person can be detected in his absence.

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- (4) Persons having physical custody of assets must not be permitted to have access to the books of accounts.
- (5) There should be an accounting control in respect of each important class of assets, in addition, these should be periodically inspected so as to establish their physical condition.
- (6) The system of Budgetary Control should be introduced.
- (7) For stock-taking, at the close of the year, trading activities should, if possible, be suspended. The task of stock-taking, and evaluation should be done by staff belonging to other than stock section.
- (8) The financial and administrative powers should be sub divided very judiciously and the effect of such division should be reviewed periodically.
- (9) Finally, the system must be capable of being expanded or contracted to correspond to the size of the concern.

**Question 5**

- (a) *X Ltd is engaged in the business of newspaper and radio broadcasting. It operates through different brand names. During FY 12-13 it incurred substantial amounts on external trade, business communication and branding expenses by participation in various corporate social responsibility initiatives. The company expects to benefit by this expenditure by attracting new customers over a period of time and accordingly it has capitalized the same under brand development expenses and intends to amortize the same over the period in which it expects the benefits to flow. As the statutory auditor of the company do you concur? Give reasons. (4 Marks)*
- (b) *M Limited is going to acquire S Limited. The purchase consideration has been decided at ₹ 4000 Crores. M Limited is worried about hidden liabilities or overvalued assets of S Limited and approached you to examine the same. List out eight important transactions/items which you would like to investigate in the Due Diligence exercise. (4 Marks)*
- (c) *Mr. X, a young chartered accountant, wants to start practice and he requires your advice, among other things, on criminal liabilities of an auditor under the Companies Act, 1956. Kindly guide him. (4 Marks)*
- (d) *X Ltd closed its manufacturing operations and sold all its manufacturing fixed assets during the financial year ended 31st March, 2013. However it intends continue its operations as a trading company. In respect of other fixed assets, the company carried out a physical verification as at the end of 31st March, 2013 and found a material discrepancy to the tune of ₹ 1 lac, which was written off and is disclosed separately in the profit and loss account. Kindly incorporate the above in your audit report. (4 Marks)*

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**Answer**

- (a) As per AS-26 on "Intangible Assets", expenditure on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria.

In the given case, it incurred substantial amounts on external trade, business communication and branding expenses by participation in various corporate social responsibility initiatives. The company expects to benefit by this expenditure by attracting new customers over a period of time and accordingly it has capitalized the same under brand development expenses. Here, no intangible assets or other asset is acquired or created that can be recognized.

Therefore the accounting treatment by the company to amortize the entire expenditure over the period in which it expects the benefits to flow is not correct and the same should be debited to the profit & loss account.

- (b) The objective of the Due Diligence exercise will be to look specifically for any hidden liabilities or over-valued assets.

Important transactions/ items which need to be investigated in the due diligence exercise are-

**Items of Hidden liabilities:**

- ◆ The company may not show any show cause notices which have not matured into demands, as contingent liabilities. These may be material and important.
- ◆ The company may have given "Letters of Comfort" to banks and Financial Institutions. Since these are not "guarantees", these may not be disclosed in the Balance sheet of the target company.
- ◆ The 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. These may not be reflected in the books of accounts of the company.
- ◆ Product and other liability claims; warranty liabilities; product returns/discounts; liquidated damages for late deliveries etc. and all litigation
- ◆ Tax liabilities under direct and indirect taxes
- ◆ Long pending sales tax assessments
- ◆ Pending final assessments of customs duty where provisional assessment only has been completed.
- ◆ Agreement to buy back shares sold at a stated price.
- ◆ Future lease liabilities
- ◆ Environmental problems/claims/third party claims

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- ◆ Unfunded gratuity/superannuation/leave salary liabilities; incorrect gratuity valuations.
- ◆ Huge labour claims under negotiation when the labour wage agreement has already expired.

**Items of over-valued assets:**

- ◆ Uncollected/uncollectable receivables
  - ◆ Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with name of company
  - ◆ Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.
  - ◆ Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue
  - ◆ Litigated assets and property
  - ◆ Investments carried at cost though realizable value is much lower
  - ◆ Investments carrying a very low rate of income / return
  - ◆ Infertuous project expenditure/deferred revenue expenditure etc.
  - ◆ Group Company balances under reconciliation etc.
  - ◆ Intangibles of no value
- (c) The circumstances in which an auditor can be prosecuted under the Companies Act, 1956 and the penalties to which he may be subjected are briefly stated below:
- (i) Under section 63 an auditor is criminally liable for making any misstatement (untrue statement in a prospectus) and can be sentenced to a term of imprisonment extending to two years or a fine of ₹ 50,000 or to both. But he can be so charged only if he has authorised the issuance of the prospectus. The charge may also fail if he is able to prove that the statement complained of is either immaterial or that he had reasonable ground to believe, and in fact he did believe up to the time of issue of the prospectus, that the statement was true.
  - (ii) Under section 628 an auditor is liable for criminal prosecution, if he in any return, certificate, balance sheet, prospectus, statement or other document required by or for the purpose of the Act, makes a statement (a) which is false in any material particular knowing it to be false; or (b) which omits any material fact knowing it to be material. If convicted, he can be punished with imprisonment for a term extending to two years and also with a fine.

This section, presumably, is applicable only to false statements which are not specifically punishable under any section of the Act. It penalizes the making of a

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false statement in any document required by or for the purposes of complying with the provisions of the Act.

- (d) Paragraph 4(i)(c) of the CARO, 2003 requires the auditor to comment, in case where a substantial part of the fixed assets has been disposed off during the year, whether such disposal has affected the going concern status of the company.

Paragraph 4(i)(b) Requires whether the fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account.

**Para in the Audit Report-**

We have made our viewpoint from the facts of the case and on the basis of guidance drawn from AS 1. We report as under-

As per Accounting Standard (AS) 1, "Disclosure of Accounting Policies", "the enterprise is normally viewed as a going concern, that is as continuing its operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations." Although the company has disposed off its manufacturing fixed assets during the financial year ending on 31-03-2013, it is still a going concern in the form of a trading company. We also report that on physical verification of other fixed assets, a material discrepancy to the tune of ₹ 1 Lac was noticed and that the same has been properly dealt with in the books of account.

**Question 6**

- (a) *M Ltd. intends to intensify its advertisement strategy of hoarding advertisements to increase its sale during the impending festival season. You have been appointed as the special auditor to examine the expenditure under this head. What will be usual evidence you will look for in this case to justify the expenditure? (4 Marks)*
- (b) *Mr. Nigal, a Chartered Accountant in practice, delivered a speech in the national conference organized by the Ministry of Textiles. While delivering the speech, he told to the audience that he is a management expert and his firm provides services of taxation and audit at reasonable rates. He also requested the audience to approach his firm of chartered accountants for these services and at the request of audience he also distributed his business cards and telephone number of his firm to those in the audience. Comment. (4 Marks)*
- (c) *Mr. A engaged in business as a sole proprietor presented the following information to you for the FY 12-13. Turnover made during the year ₹ 124 lacs. Goods returned in respect of sales made during FY 10-11 is ₹ 20 lacs not included in the above. Cash discount allowed to his customers ₹ 1 lac for prompt payment. Special rebate allowed to customer*

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*in the nature of trade discount ₹ 5 lacs. Kindly advise him whether he has to get his accounts audited u/s 44AB of the Income Tax Act, 1961. (4 Marks)*

- (d) *Dishonest Limited, a company incorporated in India has six members in its Audit Committee. Due to recessionary conditions in India the revenue of the company is going down and there is slow down in other activities of the company. Therefore, it was expected that there would not be significant work for members of the Audit Committee. Considering the overall recession in the company and the economy, the members of the Committee decided unanimously to meet once in a year only on March 31, 2013. They reviewed monthly information system of the Company and found no errors. As an auditor of Dishonest Limited would you consider the decision taken by the Audit Committee is in line with the Clause 49 of the (SEBI) Listing Agreement? (4 Marks)*

**Answer**

- (a) **Hoarding Advertisement Expenses:** The following would be the usual evidence to justify the expenditure-
- (i) Copy of Resolution passed by the Company authorizing expenditure.
  - (ii) Examination of Quotations received from various advertising agencies.
  - (iii) Permission letter from the Municipal authorities.
  - (iv) Copies of contracts with advertising agencies.
  - (v) Bill/Invoice from advertising agency to ensure that rates charged for different types of advertisement are as per contract.
  - (vi) Receipts issued by the advertising agencies.
- (b) Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means. Such a restraint has been put so that the members maintain their independence of judgment and may be able to command respect from their prospective clients.

Section 7 of the Chartered Accountants Act, 1949 read with Clause 7 of Part I of the First Schedule to the said Act prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a chartered accountant in documents through which the professional attainments of the member would come to the notice of the public. Under the clause, use of any designation or expression other than chartered accountant for a chartered accountant in practice, on professional documents, visiting cards, etc. amounts to a misconduct unless it be a degree of a university or a title indicating membership of any other professional body recognised by the Central Government or the Council.

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Member may appear on television and films and agree to broadcast in the Radio or give lectures at forums and may give their names and describe themselves as Chartered Accountants. Special qualifications or specialized knowledge directly relevant to the subject matter of the programme may also be given but no reference should be made, in the case of practicing member to the name and address or services of his firm. What he may say or write must not be promotional of his or his firm but must be an objective professional view of the topic under consideration.

Thus, it is improper to use designation "Management Expert" since neither it is a degree of a University established by law in India or recognised by the Central Government nor it is a recognised professional membership by the Central Government or the Council. Therefore, he is deemed to be guilty of professional misconduct under both clause (6) and Clause (7) as he has used the designation "Management Expert" in his speech and also he has made reference to the services provided by his firm of Chartered Accountants at reasonable rates. Distribution of cards to audience is also a misconduct in terms of Clause 6.

- (c) The following points merit consideration as stated in the Guidance note on Tax Audit issued by the Institute of Chartered Accountants of India-
- (i) Price of goods returned should be deducted from the figure of turnover even if the return are from the sales made in the earlier years.
  - (ii) Cash discount otherwise than that allowed in a cash memo/sales invoice is in the nature of a financing charge and is not related to turnover. The same should not be deducted from the figure of turnover.
  - (iii) Special rebate allowed to a customer can be deducted from the sales if it is in the nature of trade discount.

Applying the above stated points to the given problem,

1. Total Turnover	124 Lacs
2. Less – Goods Returned	20 Lacs
3. Less: Special rebate allowed to customer in the nature of trade discount would be deducted.	5 Lacs

Balance 99 Lacs

As the limit for tax audit is ₹ one crore, therefore, he would not be required to get his accounts audited under section 44AB of the Income Tax Act, 1961.

- (d) One of the following additional requirement as stipulated under clause 49 on which Section 292A (relating to audit committee) is silent is – The audit committee shall meet at least four times in a year. The gap between two meetings should not be more than four month.

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Besides, there is a mandatory review requirement and to review only monthly information system is not sufficient. Here the audit committee members reviewed only monthly information system of the company and the same is not sufficient as per clause 49.

The Audit Committee shall mandatorily review the following information as per Clause 49:

- (1) Management discussion and analysis of financial condition and the results of operations;
- (2) Statement of significant related party transactions (as defined in the audit committee) submitted by the management
- (3) Management letters/letters of internal control weaknesses issued by the statutory auditors;
- (4) Internal audit reports relating to internal control weaknesses; and
- (5) The appointment, removal and terms of remuneration of the Chief Internal auditor shall be subject to review by the Audit Committee.

Applying the above, the decision taken by the audit committee is not in line with the clause 49 of the (SEBI) Listing Agreement.

#### Question 7

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

- (a) *Scope of peer review* (4 Marks)
- (b) *Cost records in respect of by products* (4 Marks)
- (c) *Content of Management Discussion and Analysis* (4 Marks)
- (d) *Aspects to be covered in the books of accounts to be maintained by a multi-state co-operative society.* (4 Marks)
- (e) *Environment Impact Assessment* (4 Marks)

#### Answer

- (a) **Scope of peer review:** The Statement on Peer Review lays down the scope of review to be conducted as under:

The Peer Review process shall apply to all the assurance services provided by a Practice Unit.

1. Once a Practice Unit is selected for Review, its assurance engagement records pertaining to the Peer Review Period shall be subjected to Review.
2. The Review shall cover:
  - (i) Compliance with Technical, Professional and Ethical Standards:
  - (ii) Quality of reporting.
  - (iii) Systems and procedures for carrying out assurance services.

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- (iv) Training programmes for staff (including articled and audit assistants) concerned with assurance functions, including availability of appropriate infrastructure.
  - (v) Compliance with directions and/or guidelines issued by the Council to the Members, including Fees to be charged, Number of audits undertaken, register for Assurance Engagements conducted during the year and such other related records.
  - (vi) Compliance with directions and/or guidelines issued by the Council in relation to article assistants and/or audit assistants, including attendance register, work diaries, stipend payments, and such other related records.
- (b) **Cost records in respect of By-products:** Proper records should be maintained for each item of by-product, if any, showing the receipts, issues and balances both in quantity and value. The basis adopted for valuation of the by-products should be equitable and consistent. Records indicating the actual sales realisation of by-products should be maintained. If any expenses have been incurred in further process of by-products, such expenses should also be separately stated. The treatment of realization of By-products in the determination of cost of main product should also be mentioned.
- (c) **Content of Management Discussion and Analysis :**
- (1) As part of the directors' report or as an addition thereto, a Management Discussion and Analysis report should form part of the Annual Report to the shareholders. This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company's competitive position:
    - (i) Industry structure and developments.
    - (ii) Opportunities and Threats.
    - (iii) Segment-wise or product-wise performance.
    - (iv) Outlook
    - (v) Risks and concerns.
    - (vi) Internal control systems and their adequacy.
    - (vii) Discussion on financial performance with respect to operational performance.
    - (viii) Material developments in Human Resources/Industrial Relations front, including number of people employed.
  - (2) Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)

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- (d) **Aspects to be covered in the Books of Accounts to be maintained by a Multi-state co-operative society** - As per Multi-State co-operative society rules 2002, every Multi-State co-operative society shall keep books of account with respect to
1. all sum of money received and expended and matters in respect of which the receipt and expenditure take place;
  2. all sale and purchase of goods;
  3. the assets and liabilities;
  4. in the case of a Multi-State co-operative society engaged in production, processing and manufacturing, particulars relating to utilization of materials or labour or other items of cost as may be specified in the bye-laws of such a society.
- (e) **Environment Impact Assessment** – The Environmental Impact Assessment (EIA) is usually are pre-requisites to start an industry. This is done considering the known spheres of activities on the existing environmental conditions. But the predictions necessarily deviate from the actual happenings when the industry starts working. To accommodate the deviation in the system is also to be incorporated in the EIA report, if it is noticed that the degradation to the environment caused on the establishment and running of the industry is much higher than what was predicted, the mitigatory measures suggested must also be furthered.

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