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PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

QUESTIONS

1. Comment on the following as auditor:

   (a) Pinky Ltd has not made any provision in its accounts as regards losses sustained by its subsidiaries Beenu Ltd and Chinu Ltd. However, it has credited to the profit and loss account the dividend declared by its subsidiaries Akash and Xavior Ltd.

   (b) AB Ltd purchased on 1.4.2009 a machinery from a foreign country at a price $ 1,50,000 upon terms of credit that price should be settled within six months of the date of purchase. The company capitalised the asset and created a liability for the capital goods converting the foreign currency liability to Indian Rupees at a rate of exchange prevailing as on 1.4.2009. When the company settled the liability on 18.7.2009, it had to incur an additional amount of Rs.6,75,000 due to foreign exchange rate on the date of settlement. It added this additional amount of exchange variation in the capital cost of the asset and charged depreciation upon an enhanced amount of asset value from 18.7.2009.

   (c) What are the requirements of the Companies Act, 1956 regarding the disclosure of moneys raised by public issues ?

   (d) Can the reduction in carrying amount of investments/loss on disposal of investments be directly debited to "investment reserve" ?

2. Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

   (a) A chartered accountant in practice created his own website in attractive format and colours and circulated the information contained in the website through E-mail.

   (b) A chartered accountant in practice takes up the appointment as managing director of a public limited company.

   (c) S, a practicing chartered accountant gives power of attorney to an employee chartered accountant to sign reports and financial statements, on his behalf.

   (d) A is the auditor of Z Ltd., which has a turnover of Rs.200 crores. The audit fee for the year is fixed at Rs.50 lakhs. During the year, the company offers A an assignment of management consultancy within the meaning of Section 2 (2) (iv) of the CA Act, 1949 for a remuneration of Rs.1 crore. A seeks your advice on accepting the assignment.

3. Comment on the following with reference to the Chartered Accountants Act, 1949 and Schedules thereto:

   (a) Mr. S, a Chartered Accountant published a book and gave his personal details as the author. These details also mentioned his professional experience and his present association as partner with M/s RST, a firm.

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(b) Mr. C accepted the statutory audit of M/s PSU Ltd., whose net worth is negative for the year 2007-08. The audit was to be conducted for the year 2008-09. The audited accounts for the year 2008-09 showed liability for payment of tax audit fees of Rs.15,000 in favour of Mr. E, the previous auditor.

(c) M/s PQR, a firm of Chartered Accountants with 5 partners has accepted the audit of ABC Pvt. Ltd. for 2008-09 at an audit fee of Rs.2,500. ABC Pvt. Ltd was incorporated in April, 2006, but had commenced operations in January, 2009.

(d) Mr. P, a Chartered Accountant in practice entered into a partnership with Mr. L, an advocate for sharing of fees for work sent by one to the other. However, due to some disputes, the partnership was dissolved after 1 month without any fees having been received.

4. (a) Give your opinion on whether the following persons can be appointed auditors of a limited company or not:

   (i) A firm of chartered accountants in practice, a partner of which is a secretary of the company.

   (ii) A member of the Institute of Chartered Accountants of India, who is of unsound mind, holding a certificate of practice.

   (b) In a Company, it is suspected that there has been an embezzlement in cash receipts. As an investigator, what are the areas that you would verify?

5. State the procedure to determine the value of listed and unlisted equity securities and derivative instruments of an insurance company.

6. (a) A leading jewellery merchant used to value his inventory at cost on LIFO basis. However, for the current year, in view of requirements of AS 2, he changed over to FIFO method of valuation. The difference in value of stock amounted to Rs.55 lakhs which is higher than that under the previous method. In such a situation, what are the reporting responsibilities of a Tax Audit under Section 44AB of Income Tax Act, 1961.

   (b) Write briefly the method of accounting in Form No. 3CD of Tax Audit.

7. (a) As an internal auditor for a large manufacturing concern, you are asked to verify whether there are adequate records for identification and value of plant and machinery, tools and dies and whether any of these items have become obsolescent and not in use. Draft a suitable audit programme for the above.

   (b) Explain briefly the concept of tagging and tracing with suitable examples.

8. (a) Mention different types of frauds that are possible in credit sales, and state in what way an auditor should proceed to detect them.

   (b) List steps which an auditor should take to minimise the danger of claims against him for negligent work.

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9. Answer the following:

   (a) As on 31-3-2009, there was a claim for damage from one of the customers against the company engaged in selling of accounting software for an alleged failure to provide after sales services in relation to the software purchased from it. Before finalisation of accounts for the year ended 31-3-2009 (the accounts were finalised on 14th June, 2009), the company won the case and had no liability whatsoever in this regard. The company has made a provision for this contingent liability in its accounts for the year ended 31-3-2009, which it says, will be reversed in the next year.

   (b) Write short notes on the following:

      (i) Cut-off Procedures

      (ii) Situations where external confirmations can be used.

10. As a statutory auditor, how would you deal with the following:

   (a) PQ Ltd., as part of overall cost cutting measure announced voluntary retirement scheme (VRS) to its employees, to reduce the employee strength. During the first half year ended 30.9.2009 the company paid a compensation of Rs.72 lakhs to those who availed the scheme. The Chief Accountant has reflected this payment as part of regular salaries and wages paid by the company. Is this correct?

   (b) During the course of statutory audit of an investment company dealing in shares and securities, in spite of repeated reminders by the statutory auditor, the company officials did not provide the investments held by the company at the Balance Sheet date for verification and also did not provide the details for valuation of unlisted shares as on the Balance Sheet date. The statutory auditor, in his final audit report to the shareholders, reported as follows:

   "Subject to the verification of the existence and value of the investments, the Balance Sheet shows a true and fair view."

   Is the report made by the Statutory auditor correct?

   (c) Apex Ltd., a well reputed manufacturing public limited company has made a contribution of Rs. 2.5 lacs during the financial year ended 31.3.08 to a political party for running a school, situated in the village, where most of the workers of the company reside. It is admitted that the benefit of the school is mostly for the children of the workers of the company. The company has not made any profits in the last four years.

11. As a Statutory Auditor, how would you deal with the following?

   (a) ABC Ltd. commenced construction of a flyover in Mumbai in January, 2007 under BOLT scheme. The same was completed in February, 2008. Due to seasonal heavy rains in July, 2007 in the area, the work on the flyover had to be suspended for 1 month. The company accordingly suspended borrowing costs of Rs. 12.50 lakhs for that month from capitalisation.

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(b) LM Ltd. has 2 divisions L and M. The finished products of division L are transferred to division M where further processing is carried out before sale to customers. To achieve transparency and accountability between the divisions, division L raises an invoice on division M at cost plus normal margins. At the year end the unrealised profits on inter-division stocks are eliminated. However, the transfers are recorded at the invoice value as sales and purchases in the respective divisions for the purpose of preparing the Profit and Loss Account. Suitable disclosures, for this are given in then 'Notes to Accounts'.

(c) T Pvt. Ltd. is an unlisted closely held company with turnover less than Rs.50 crores. While finalising the accounts, Mr. M the Director (finance) disputed the applicability of AS 20 to the company.

12. (a) Distinguish between "Quoted Investment" and "Trade Investment".

(b) Comment on the following as auditor : Interest paid or payable to the managing director or manager has not been shown separately in profit and loss account on the ground that it is not even 0.1% of total interest paid / payable.

13. (a) As the Statutory Auditor of a Manufacturing Company, what are the points you will consider to conclude "Whether the company has an Internal Audit system commensurate with the size of the company and its operations"?

(b) Briefly describe the Auditor's responsibilities regarding disqualification of Directors.

14. (a) "An auditor while analysing the errors in a sample need not consider the qualitative aspects of errors detected." Please comment.

(b) As an internal auditor for a large manufacturing concern, you are asked to verify whether there are adequate records for identification and value of Plant and Machinery, tools and dies and whether any of these items have become obsolescent and not in use. Draft a suitable audit programme for the above.

15. (a) What are the important aspects to be looked into a due diligence review of Cash flow?

(b) What is the meaning of "Small and Medium sized Company" as per the Companies (Accounting Standards) Rules, 2006?

16. "Like every other audit, a systematic planning for cost audit is also necessary". Indicate the matters to be included in a Cost Audit Programme.

17. (a) Explain briefly the solvency margin in case of an insurer carrying on general insurance business.

(b) Write short notes on the following with suitable examples:

(i) Principal enactments governing bank audit.

(ii) Types of market under National Exchange Automated Trading (NEAT).

18. (a) What are the disclosure requirements of Schedule VI to the Companies Act, 1956 regarding foreign exchange expenditure and foreign exchange earnings?

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(b) As an Auditor, comment on the following: PQ Ltd. has given donations of Rs.50,000 each to a charitable school and a trust for blinds, during the year ended 31-3-2009. The average net profit of the company during last three financial years amounts to Rs.12 lacs.

(c) 'In vouching payments, the auditor does not merely check proof that money has been paid away'. Discuss.

19. (a) SK Ltd. has fully computerised its accounting operations. The stock records are maintained up to date with timely entries passed for all receipts and issues. The company has hired as professional security agency, which monitors and implements a close vigilance over the operations of the company. As such, the company had dispensed with the practice of taking stock of their inventories as at the year end as in their opinion the exercise is redundant, time consuming and intrusion to normal functioning of the operations.

(b) XLW has a branch office in Malaysia. The company has appointed Mr. X, who is qualified to audit accounts as per Malaysian laws. Mr. Z, the statutory auditor objects to the same, contending that he alone can audit the branch office accounts. Discuss. Can Mr. Z visit the branch?

(c) Mr. P is the statutory auditor of S Ltd. which has a branch in Pune. The company in general meeting decided to have the accounts of Pune Branch audited by Mr. Q who was appointed without Mr. P's knowledge and consent. State your comments on the above with reasons.

20. (a) A company was engaged in the business of buying IMFL (Indian Made Foreign Liquor) and beer and selling same through retail vending shops and bars run by it. The company sold beer to some of the customers who consumed them in bars run by it and left the bottles behind. (Technically, these bottles were the property of the customers.) These bottles were later on disposed off by the company. So, the issues are:

1. Are these bottles left behind by the customers "assets" of the company?
2. Are they "inventories"?
3. If they are "inventories", how they should be valued?
4. Can the "bottles" be valued at net realisable value and treated as "income"?

(b) In case of entities like companies which present its financial statements on accrual basis, cash flow statement fulfils vital information needs of users. Do you agree?

SUGGESTED ANSWERS/HINTS

1. (a) Clause 3 (xiii) of Part II of Schedule VI to the Companies Act, 1956 only requires that the profit and loss Account shall disclose "Provisions for losses of subsidiary companies". In other words, if company has made such a provision, the same

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should be distinctly disclosed. It is important to note that Schedule VI to the Companies Act, 1956 deals with only presentation of the various items of income and expenses, assets and liabilities. It does not deal with recognition and measurement of various items of income and expenses, assets and liabilities. Recognition and measurement should be in accordance with the Accounting Standards notified vide the Companies (Accounting Standards) Rules, 2006. [Simplex Concrete Piles (India) Ltd. v. Union of India (2007) 79 SCL 317 (Cal.)]. As Accounting Standards do not require the company to recognise a provision in respect of losses of subsidiary companies, company has done no wrong in not making any provision for losses. However, company should recognise any "other than temporary" diminution in value of its investments in subsidiaries Beenu Ltd. and Chinu Ltd. in accordance with AS 13. Company is justified in crediting to the profit and loss account the dividend by its subsidiaries Akash and Xavior Ltd. in accordance with AS 9.

(b) The company has followed the accounting treatment prescribed by Schedule VI to the Companies Act, 1956. The treatment followed by the company is correct for all accounting years commencing prior to 7-12-2006. It is not valid with effect from Financial year 2007-08. The Central Government notified the Accounting Standards I - 29 issued by ICAI as the Accounting Standards under Section 211 (3C) of the Companies Act, 1956 vide the Companies (Accounting Standard) Rules, 2006 w.e.f. 7-12-2006. The treatment in the notified Accounting Standards shall apply for all accounting periods commencing on or after 7-12-2006. (i.e. effectively from financial year 2007-08 as per Press Release of the Central Government). Foot Note No. 5 to AS 11 [Companies (Accounting Standards) Rules, 2006] provides that the accounting treatment of exchange differences contained in AS 11 is required to be followed irrespective of the relevant provisions of Schedule VI to the Companies Act, 1956. Therefore, in view of the above, the additional amount of Rs.6,75,000 should be charged to profit and loss account in accordance with AS 11 notified by the Central Government.

(c) Para 4 (xx) of CARO, 2003 requires the auditor to state in his audit report whether the management has disclosed on the end use of money raised by public issues (in notes to accounts) and the same has been verified by the auditor. Schedule VI requires that all unutilised monies out of the issue must be separately disclosed in the balance sheet of the company indicating the form in which such unutilised funds have been invested.

(d) Clause 3 (xii) (a) of Part II of Schedule VI to the Companies Act, 1956 requires the profit and loss account shall disclose the following information:

"Profits or losses on investments showing distinctly the extent of the profits or losses earned or incurred on account of a membership of a partnership firm to the extent not adjusted from any previous provision or reserve."

Note – Information in respect of this item should also be given in the balance sheet under the relevant provision or account.

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Para 34 of AS 13 requires that on disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged (or credited) to the profit and loss statement. Para 33 of AS 13 requires that any reduction in the carrying amount and any reversals of such reduction should be charged or credited to the profit and loss statement.

The Calcutta High Court has ruled in Simplex Concrete Piles (India) Ltd. v. Union of India [2007] 79 SCL 317 that Schedule VI to the companies Act,1956 deals with only presentation of the various items of income and expenses, assets and liabilities. It does not deal with recognition and measurement of various items of income and expenses, assets and liabilities. Recognition and measurement should be in accordance with the Accounting Standards notified vide the Companies (Accounting Standards) Rules, 2006. Furthermore, in J. K. Industries Ltd. v. Union of India [2007] 80SCL283, the Supreme Court ruled that sub-section (3A)/(3B)/(3C) of Section 211 shall override sub-section (1)/(2) of Section 211 in case of any conflict. Therefore, AS will override Schedule VI in case of a conflict. Therefore, reduction in carrying amount or loss on disposal should be charged to Profit and Loss account and not to Investment Reserve. However, matching amount can be transferred from the Investment Reserve to the credit of Profit and Loss account to offset the impact of the loss.

2. (a) **Creation of own website by a Chartered Accountant/firm of Chartered Accountants:** The guidelines approved by the Council of the Institute of Chartered Accountants of India permits creation of own website by a chartered accountant in his or his firm name and no standard format or restriction on colours is there. The chartered accountant or firm, as per the guidelines, should ensure that none of the information contained in the website be circulated on their own or through E-mail or by any other mode except on a specific “Pull” request.

   Since in the given case, the chartered accountant circulated the information contained in the website through E-mail, he is guilty of misconduct under clause 6 of Part I of the First Schedule to the Chartered Accountants Act, i.e., a chartered accountant in practice is deemed to be guilty of professional misconduct if he solicits client or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means.

   (b) **Appointment of a CA in practice as MD of a Public Limited Company:** Under clause 11 of Part I of First Schedule to the Chartered Accountants Act, a chartered accountant in practice is deemed to be guilty of professional misconduct, if he engages in any business or occupation other than the profession of chartered accountants, unless permitted by the council so to engage.

   However, nothing contained in clause 11 shall disentitle a chartered accountant from being a director of a company, unless he or any of his partners is interested in such company as an auditor.

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Regulation 190A, states a member in practice cannot engage himself in any business or occupation other than that of a chartered accountant except when permitted by the council. As per Appendix 10 of CA Regulations, 1988, a CA in practice may hold the office of a Managing Director a Whole-time Director of a body corporate, provided that the member and/or his relatives do not hold substantial interest in such concern, after obtaining the specific and prior approval of the Council.

He should seek prior approval of the council otherwise he would be held guilty of misconduct.

(c) Power of signing reports and financial statements: Under clause 13 of Part I of First Schedule to the Chartered Accountants Act a CA in practice is deemed to be guilty of professional misconduct if he allows a person not being a member of the Institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

This clause read in conjunction with Section 26 of the CA Act,1949 stipulates that no person other than the member of the institute shall sign any document on behalf of a CA in practice or a firm of CA' s in his or its professional capacity.

The term 'Financial Statement' for this purpose would cover an examination of the accounts or financial statements given under a statutory enactment or otherwise. Accordingly S is guilty of professional misconduct under clause 13 of part I of First Schedule and also under clause (1) of Part II of Second Schedule for contravening Section 26.

(d) Appointment as a statutory auditor of a PSUs' / Govt. company / companies / listed company / companies and other public company / companies: In exercise of the powers conferred by clause (ii) of part II of the Second Schedule to the CA Act, 1949, the Council of ICAI specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct if he accepts the appointment as a statutory auditor of a PSUs'/Govt company/companies/ listed company/companies and other public company/companies having a turnover of Rs.50 crores or more in a year and accepts any other work(s) or assignment(s) or service(s) in regard to same undertaking(s) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same undertaking. In view of the above position it would be a misconduct on A's part if he accepts the management consultancy assignment for a fee of Rs.1 crore.

3. (a) Soliciting professional work: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 refers to professional misconduct of a member in practice if he solicits client or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means. Therefore, members should not adopt any indirect methods to advertise their professional practice with a view to gain publicity and thereby solicit clients or professional work. Such a restraint must be practised so that members may

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maintain their independence of judgement and may be able to command the respect of their prospective clients. While elaborating forms of soliciting work, the Council has specified that a member is not permitted to indicate in a book or an article, published by him, the association with any firm of chartered accountants. In this case, Mr. S a chartered accountant, published the book and mentioned his professional experience and his association as a partner with M/s RST, a firm of chartered accountants.

Mr. S being a chartered accountant in practice has committed the professional misconduct by mentioning that at present he is a partner in M/s. RST, a chartered accountants firm.

(b) Accepting appointment as an auditor: As per notification issued by the Council under Clause (ii) of Part II of the Second Schedule, a member of the Institute of Chartered Accountants of India in practice shall be deemed to be guilty of professional misconduct if he accepts appointment as auditor of an entity in case the undisputed audit fee of another chartered accountant for carrying out the statutory audit under Companies Act, 1956 or various other statutes has not been paid.

As per the proviso, such prohibition shall not apply in case of a sick unit where a sick unit is defined to mean "where the net worth is negative".

In the instant case, though the undisputed fees are unpaid, Mr C would still not be guilty of professional misconduct since the M/s PSU Ltd. is a sick unit having negative net worth for the year 2007-08.

(c) Accepting audit below certain fees: Under Clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council has notified that if a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he on behalf of the firm in which he is a partner consisting of 4-8 partners with at least one partner holding a certificate of practice for five years or more accepts or carries out any audit work involving receipt of audit fees of an amount less than Rs.3,000 / Rs.5,000 depending on the population of the city in which it is located. It has been further provided that such a restriction shall not apply to audit of newly formed firms relating to 2 accounting years from the date of commencement of their operations.

In the instant case, though the audit fees of Rs.2,500/- less than that prescribed, but in view of the fact that operations have been commenced by the company M/s ABC Pvt. Ltd. only in January 2009, M/s PQR, chartered accountant, would not be hit by this notification and therefore, would not be guilty of any professional misconduct.

(d) Partnership with non-chartered accountants: As per clause 4 of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant will be guilty of professional misconduct if he enters into partnership with any person other than a chartered accountant in practice or a person resident without India who but for his residence abroad would be entitled to be registered as a member under

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Claus (v) of Sub-section (1) of Section 4 or whose qualification are recognised by the Central Government or the Council for the purpose of permitting such partnership.

This clause puts a restriction on entering into partnership with a non-chartered accountant for the practice of the profession of chartered accountancy. In the instant case since Mr. P, a chartered accountant, has entered into partnership with Mr. L, an advocate, he would be guilty of professional misconduct irrespective of the fact that no work or fee was shared and the partnership was dissolved after one month since the clause does not permit entering into partnership.

4. **(a)** (i) As one of the partners of the firm is the secretary of the company, the firm cannot be appointed as the auditors of the company. A secretary is an employee of the company and according to Section 226(3b) of the Companies Act, 1956, an employee of the company cannot be appointed its auditor.

(ii) A member of the Institute of Chartered Accountants of India, holding a certificate of practice, can be appointed as an auditor of the company even if he is of unsound mind provided he has not been adjudged a man of unsound mind by a competent court. Hence, so long as he has not been adjudged a man of unsound mind, he may be so appointed.

(b) The following areas need to be verified in this regard:

(i) Issuing a receipt for full amount collected, entering only a lesser amount on the counterfoil.

(ii) Showing a larger cash discount than actually allowed.

(iii) Adjusting a fictitious credit in the account of a customer for goods returned.

(iv) Cash sales entered as credit sales with debit to customer.

(v) Writing off a good debt as bad and irrecoverable to cover up misappropriation of amount collected.

(vi) Short-debiting customer's ledger account and withdrawing the difference on collection of full amount.

(vii) Under-casting the receipts side of cash book; carrying over a shorter total of the receipts from one page of the cash book to the next so as to cover up short banking misappropriated.

(viii) Over-casting the payment side of the cash book; over-carrying the total of the payments from one page of the cash book to the next so as to cover up misappropriation of a part of the amount withdrawn from the bank.

5. **Procedure to determine the value of listed and unlisted equity securities and derivative instruments of an insurance company:** Equity securities and derivative instruments that are traded in active markets, shall be measured at fair value as at the balance sheet date. Fair value will be the lowest of the last quoted closing price of the stock exchanges where the securities are listed. The insurance company shall assess on

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each balance sheet date whether any impairment of listed security/derivative instruments has occurred.

An active market shall mean a market, where the securities traded are homogeneous, availability of willing buyers and sellers is normal and the prices are publicly available.

Unrealised gains/losses arising due to changes in fair value of listed equity shares and derivative instruments shall be taken to equity under the head 'Fair Value Change Account'. The 'profit' on sale of investments' or 'loss on sale of investments', as the case may be, shall include accumulated changes in the fair value previously recognised in equity under the heading Fair Value Change Account in respect of particular security and being recycled to profit and loss account on actual sale of that listed security.

Any credit balance in Fair Value Change Account will not be available for distribution as dividends. Also any debit balance in such an account shall be reduced from profits/free reserves while declaring dividends.

At every balance sheet date, impairment loss should be recognised as an expense to the extent of the difference between the re-measured fair value of the security and its acquisition cost as reduced by any previous impairment loss already recognised. Any reversal of impairment loss earlier recognised as an expense, should be recognised in the Revenue/Profit & Loss Account.

Unlisted and other than actively traded equity securities and derivative instruments will be measured at historical costs. Provision shall be made for diminution in value of such investments. The provision so made shall be reversed in subsequent periods if estimates based on external evidence show an increase in the value of investments over its carrying amount. The increased carrying amount of the investments due to reversal of the provision shall not exceed the historical cost.

6. **(a)** The change in the method of valuation of stock is not a change in method of accounting, as it is only a change in accounting policy. However in the Income Tax Act, 1961 this is considered under method of accounting. Under the Income-Tax Act, 1961 if the change in method of valuation is bonafide, and is regularly and consistently adopted in the subsequent years as well, such change would be permitted to be made for tax purposes. In the instant case, the change in the valuation of stock from LIFO basis to FIFO basis is pursuant to mandatory requirements of the AS 2 'Valuation of Inventories' and therefore should be viewed as bonafide change.

(b) The tax auditor in his report has to specifically refer to the method of valuation of stock under Clause 12 in Form 3CD.

(i) Method of valuation of closing stock employed in the previous year.

(ii) Details of deviation, if any, from the method of valuation prescribed under section 145A and the effect thereof on profit or loss.

The auditor has to see that the method of stock valuation is followed consistency from year to year. It is also necessary to ensure that method followed for valuation

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of stock results is correct profits or gain. The change from LIFO to FIFO is bonafide, the disclosure of which would have to be made the financial statements. As far as Section 145A is concerned, the tax auditor need not change the method of valuation of purchases, sales and inventories which is regularly employed by the assessee. All that he has to do is to adjust the valuation for any tax, duty, cess or fee actually paid or incurred by the assessee, if the same had not already been adjusted.

7. (a) The internal Audit Programme in connection with Plant and Machinery and Tools and dies may be on the following lines:

(i) Internal Control Aspects: The following may be incorporated in the audit programme to check the internal control aspects:

(a) Maintaining separate register for hired assets, leased asset and jointly owned assets.

(b) Maintaining register of fixed asset and reconciling to physical inspection of fixed asset and to nominal ledger.

(c) All movements of assets are accurately recorded.

(d) Authorisation be obtained for – (i) a declaring a fixed asset scrapped, (ii) selling a fixed asset.

(e) Check whether additions to fixed asset register are verified and checked by authorized person.

(f) Proper recording of all additions and disposal.

(g) Examining procedure for the purchase of new fixed assets, including written authority, work order, voucher and other relevant evidence.

(h) Regular review of adequate security arrangements.

(i) Periodic inspection of assets is done or not.

(j) Regular review of insurance cover requirements over fixed assets.

(ii) Assets Register : To review the registers and records of plant, machinery, etc. showing clearly the date of purchase of assets, cost price, location, depreciation charged, etc.

(iii) Cost Report and Journal Register : To review the cost relating to each plant and machinery and to verify items which have been capitalised.

(iv) Code Register : To see that each item of plant and machinery has been given a distinct code number to facilitate identification and verify the maintenance of Code Register.

(v) Physical Verification : To see physical verification has been conducted at frequent intervals.

(vi) Movement Register : To verify (a) whether a Movement Register for movable equipments and (b) log books in case of vehicles, etc. are being maintained properly.

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(vii) Assets Disposal Register : To review whether assets have been disposed off after proper technical and financial advice and sales/disposal/retirement, etc. of these assets are governed by authorisation, sales memos or other appropriate documents.

(viii) Spare Parts Register : To examine the maintenance of a separate register of tools, spare parts for each plant and machinery.

(ix) Review of Maintenance : To scrutinize the programme for an actual periodical servicing and overhauling of machines and to examine the extent of utilisation of maintenance department services.

(x) Review of Obsolescence : To scrutinise whether expert's opinion have been obtained from time to time to ensure purchase of technically most useful efficient and advanced machinery after a through study.

(xi) Review of R&D : To review R&D activity and ascertain the extent of its relevance to the operations of the organisation, maintenance of machinery efficiency and prevention of early obsolescence.

(b) It is a technique better than Integrated Test Data Facility. It involves tagging the client's input data in such a way that relevant information is displayed at key points. It uses the actual data, and so the question of elimination of 'special entries' test data designed under Integrated Test Data Facility does not arise. The hard copy, so produced is available only to the auditor and may describe such inputs as hours worked in a pay period in excess of 50; or sales orders processed in excess of Rs.1,00,000. This enables the auditor to examine transactions at the intermediate steps in processing. The advantage of the tagging and tracing approach lies in the use of actual data and elimination of the need for reversing journal entries. The disadvantage is that the erroneous data will not necessary be tagged. An effective combination approach may be to use the ITF approach (integrated test facility) for a few hypothetical transactions and the tagging and tracing approach to follow line data through a complex system.

8. (a) Different types of frauds are possible in credit sales, which may include (a) misappropriation of goods returned from customers, (b) misappropriation of the payments received, and (c) inclusion of fictitious sales to inflate profits.

In order to detect frauds in credit sales as mentioned above, the auditor should proceed in the following way :

(i) In order to detect misappropriation of goods returned from the customers, the auditor should ascertain first the system of recording the goods returned and find out its weaknesses, if any. He should check the entries in the sales returns book with goods inwards book. He should also refer to the correspondence entered into between the client and the customers returning the goods, and check thoroughly all credit notes to be made along with the correspondence, goods inward book and the gates keeper's records.

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(ii) In order to detect misappropriation of payments received, the auditor would verify the statement received from the customer. The auditor would see that the balances thereon agree with the aggregate of unpaid invoices and the credit notes in the relevant customers' folder. In case of suspicion, he should write to the customer concerned ascertaining the balance, which remains unpaid, and then compare it with the records.

(iii) In order to detect inclusion of fictitious sales with a view to inflate profits, the auditor should check the sales invoices carefully. The auditor should check particularly the sales entered towards the close of the accounting period with a view to find whether sales relating to the next period have been treated as sales for the current period. He should also check the goods outward book and gatekeeper's record exhaustively with the related invoices to see that only real sales have been included in the books.

(b) Negligence, as applied to the auditor, means some act or omission, which occurs because the auditor has failed to exercise that degree of professional care and skill, appropriate to the circumstances of the case, which is expected of him.

The steps, which an auditor should take to minimize the danger of claims against him for negligent work, are as follows:

(i) Issue a letter of engagement in which the scope of work and the extent of the responsibilities undertaken should be clearly set out distinguishing between audit duties and other services.

(ii) In the case of audit of non-incorporated enterprises an 'accountants' report should be issued with the financial statements in which the work carried out should be clearly explained.

(iii) Ensure that the firm's standards are continuously reviewed and monitored and that they meet the minimum requirements set out in the auditing standards and guidelines issued by the Institute of Chartered Accountants of India.

(iv) Prepare well-documented, comprehensive working papers containing audit conclusions as a vital means of defense against possible claims.

(v) Ensure that there is no appropriate training programme for partners and staff to cope with current changes in accounting procedures, legislation and auditing practices.

(vi) Seek specialist advice whenever in doubt over complicated issues or recommend to the client that he should seek such advice himself.

9. (a) First and foremost, making provision of a contingent liability violates (AS) 29 'Provisions, Contingent Liabilities and Contingent Assets' issued by ICAI which categorically provides that no provision should be made for a contingent liability. Only disclosures are to be made (in the notes to the account) in respect of contingent liabilities and even such disclosures are not required if the possibility of loss is remote. Thus, the company's accounting treatment – making provision for a contingent liability violates (AS) 29.

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The impact of post 31-3-2009 development – This development has occurred after 31-3-2009 but before the date of finalisation of accounts (i.e. 14-6-2009). It should be taken into account for finalisation of accounts as it pertains to the conditions existing at the balance sheet date. The impact of this development is that even disclosures (in notes to account) [which are required to be given for contingent liabilities] are not required as it is no longer a continent liability. If this development had not taken place, the company would be required to make disclosures of the contingent liability. Now that in view of the post 31-3-2009 development it is not even a contingent liability, even disclosures in accounts are not required.

Therefore, the auditor should ask the company to rectify the accounts and reverse the provision made as on 31-3-2009 itself and also ask the company to remove any disclosures regarding this contingent liability in the notes to the accounts. If company does not do so, he should qualify his opinion on the truth and fairness of accounts and also quality his remarks regarding compliance with accounting standards which he is required to make pursuant to Section 227(3) (d) of the Companies Act, 1956.

(b) (i) Cut-off procedures: Cut-off procedures mean procedures employed to ensure the separation of transactions at the end of one year from those in the commencement of the next year. Usually, the problem of overlapping is found in inventory accounting since quite often goods are sold but passed on to the buyer only after the year is over or goods are bought but received only after the close of the year. This situation may create considerable problem for the proper stock taking of inventory. Therefore, the principal areas of application of cut-off procedures involve sales, purchases and stock. The auditor should satisfy himself by examination and test check that these procedures adequately ensure that:

(a) Goods purchased for which property has passed to the client have in fact been included in inventories and that the liability if any, has been provided for.

(b) Goods sold have been excluded from the inventories and credit has been taken for sales.

The auditor may examine a sample of documents evidencing the movement of stocks into and out of stores, including documents pertaining to period shortly before and shortly after the cut-off date, and check whether the stocks represented by those documents were included or excluded, as appropriate, during the stock-taking.

(ii) Situations where external confirmations can be used: Refer to SA 505

(i) Bank balance from bankers

(ii) Account receivable balances

(iii) Stocks held by third parties

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(iv) Property title deeds held by third parties

(v) Investments purchased but delivery not taken

(vi) Loan from lenders

(vii) Account payable balances

(viii)Long outstanding share application money.

10. (a) Accounting treatment of payment on account of VRS: As per AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" the payment made to its employees on account of VRS as an overall cost cutting measure would fall in the ambit of ordinary activities connected with the business of the enterprise. AS 5 requires that when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. In fact an activity like VRS can very well be treated as restructuring exercise carried by the enterprise. Though this is not an extraordinary item, AS 5 requires that items of income and expense which are not extraordinary items, the nature and amount of such items may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. Disclosure of such information is sometimes made in the notes to the financial statements.

Considering the above, the compensation of Rs. 72 Lakhs paid towards VRS availed by employees should be shown separately in the profit and loss account of PQ Ltd., so that the effect of it on the operating results of the Company during the previous year can be perceived. Therefore, clubbing of Rs. 72 lakhs with the regular salaries and wages of the company by the Chief Accountant is not appropriate and, thus, the separate disclosure is necessary.

(b) Failure to obtain information and explanation: The statutory auditor is required to express his opinion on the truth and fairness of financial statement audited by him only after examining the authenticity with reference to the information and explanations given to him. He must determine the extent of information which should be obtained by him before he expresses his opinion on the financial statement submitted to him for report. He should not express an opinion before obtaining the required data and information. In the given case, since the statutory auditor did not see the existence and also valuation of the investments held by the investment company the auditor, should not say "Subject to the verification of the existence and value of the investments, the balance sheet shows a true and fair view." In fact, as per facts given in the question, the auditor has not been able to obtain information and might not be able to satisfy himself by adopting other audit procedure and accordingly may have to appropriately modify the report. The auditor may state that because of these circumstances, he has been unable to form an opinion. But, reporting by the auditor that, "subject to verification of the existence

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and value of the investments, the balance sheet shows a true and fair view", the auditor is not providing information but only means to information. The situation in this case is analogous to London and General Bank's case. By reporting in the above manner auditor is not conveying any information. Rather, the auditor is arousing the suspicion of users of financial statements. Section 227(3) requires the auditor to specifically, state whether or not he has obtained all such information and explanation. If the auditor has not been able to obtain relevant information or explanations, he may have to qualify his opinion on the truth and fairness of the financial statements or express his inability to give an opinion in the matter. Thus the auditor has failed to perform his responsibilities.

(c) Restrictions regarding political contribution: Section 293-A of the Companies

Act, 1956 deals with prohibitions and restrictions regarding political contribution. A non-Government company which has been in existence for not less than three years may contribute any amount or amounts directly or indirectly to any political party or for any political purpose to any person provided that the aggregate of the amounts which may be so contributed by a company in any financial year shall not exceed 5% of its average net profits determined in accordance with the provisions of Sections 349 and 350 during the three immediately preceding financial years. The company in question has not made any profit in last four years and contributed Rs. 2.5 lacs during the year to a political party for running a school. This is violation of the provisions of Section 293-A of the Companies Act although the children of its workers are benefited. The auditor would have to qualify his report stating the contravention of the provisions of the Companies Act.

11. (a) Capitalisation of borrowing costs: Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for intended use or sale are interrupted. According to AS 16, "Borrowing Costs", capitalisation of such borrowing costs should be suspended during extended periods in which active development is interrupted. The standard, however, clarifies that capitalisation of borrowing costs is not suspended when a temporary delay is necessary as a part of the process or substantial technical and administrative work is being carried out. Thus, the test as to whether or not to capitalise the borrowing costs depends primarily upon the nature of interruption of activities during "extended periods".

In the instant case, it has been mentioned that the construction activity was interrupted due to seasonal rain and hence being regular feature. Though the rain was heavy, the period cannot be considered as an "extended period" leading to substantial delay in suspension of construction activities. Therefore, borrowing cost of Rs.12.50 lakhs incurred by ABC Ltd. should be capitalised. Hence, suspension of capitalisation by the company is not a correct treatment and statutory auditor should report accordingly.

(b) Revenue recognition: As per the definition of the term "Revenue" in AS 9, "Recognition", revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the

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sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them.

As per the clarification issued by ICAI, the use of the word "enterprise" in the above definition clearly implies that the transfers within the enterprise cannot be considered as fulfilling the definition of the term "revenue". Thus, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with AS 9. Further, in case of inter-divisional transfers, risks and rewards remain within the enterprise and also there is no consideration from the point of view of the enterprise as a whole. Thus, the recognition criteria for revenue recognition are also not fulfilled in respect of inter-divisional transfers.

In the instant case, therefore, LM Ltd cannot recognise inter-division transfers from L to M as sales and the same will have to be eliminated during finalisation. If not so done, the statutory auditor will have to qualify his report.

(c) **Applicability of Accounting Standard:** AS 20, "Earning Per Share", came into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. As such AS 20 does not mandate an enterprise, which has neither equity shares nor potential equity shares which are so listed, to calculate and disclose earnings per share, but, if that enterprise discloses earnings per share for complying with the requirements of any statute or otherwise, it should calculate and disclose earnings per share in accordance with AS 20. Part IV of Schedule VI to the Companies, Act, 1956, requires, among other things, disclosure of earnings per share. Accordingly, every company, which is required to give information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

Accordingly the company, T Pvt. Ltd should compute and disclose EPS according to AS 20. Therefore, the contention of Director (Finance) is incorrect. The auditor will have to ensure that EPS is disclosed as per AS 20 or else the auditor should appropriately modify the audit report.

12. (a) Quoted investment is an investment for which a quotation or permission to deal on a recognised stock exchange has been granted. Trade investment is an investment made by a company in shares or debentures of another company not being its subsidiary, to promote the trade or business of the first company. From the above definitions, the following points emerge:

- Investment in subsidiary's shares/ debentures may be a quoted investment if the shares/debentures are quoted on a recognized stock exchange. But

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investment in subsidiary's shares/debentures can never be a trade investment.

- Trade investment is necessarily investment in shares/debentures of company. Quoted investment need not be share/debenture of a company. It can even be Government securities quoted on a recognised stock exchange.

(b) Clause 3(v) of Part II of Schedule VI to the Companies Act, 1956 requires that the profit and loss account shall disclose interest paid or payable to the managing director or manager. In view of this specific statutory requirement, interest paid or payable to the managing director or manager are material irrespective of their quantum and should be disclosed separately. If not disclosed, auditor will have to qualify his audit report.

13. (a) This clause has mandatory application in case of companies having a paid-up capital and reserves exceeding rupees 50 lacs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crores rupees for a period of three consecutive financial years immediately preceding the financial year concerned. 'Financial year concerned' means the financial year under audit. This clause also mandatory applicable for the listed companies irrespective of the size of paid-up capital and reserves or turnover.

The auditor has to examine whether the internal audit system is commensurate with the size of the company and the nature of its business. The following are some of the factors to be considered in this regard:

(i) What is the size of the internal audit department? In considering the adequacy of internal audit staff, it is necessary to consider the nature of the business, the number of operating points, the extent to which control is decentralised, the effectiveness of other forms of internal control, etc.

(ii) What are the qualifications of the persons who undertake the internal audit work? Internal auditing is reasonable to expect that the internal audit department should normally be headed by a chartered accountant and that, depending upon the size of the department, it employs other qualified persons.

(iii) To whom does the internal auditor report? In general, the higher the level to which the internal auditor reports, the greater will be his independence.

(iv) What are the areas covered by the internal audit? Internal audit can cover a large number of areas including operational auditing, organisation and methods studies, special investigations and the like.

(v) Has the internal auditor adequate technical assistance? This can be provided either by having full-time technically qualified persons in the internal audit department or by such persons being deputed to the internal audit department for specific assignments.

(vi) What are the reports which are submitted by the internal auditor or what other

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evidence is there of his work? Auditor should satisfy himself that an internal audit system is functioning effectively. He can do so by examining the reports submitted by the internal auditor.

(vii) What is the follow-up? It is necessary that there is an adequate follow-up system to ensure that the errors pointed out are corrected and remedial action taken on the deficiencies reported upon.

(b) Auditor's responsibilities regarding disqualification of directors: Section 227(3) of the Companies Act, 1956 has recently been amended by the Companies (Amendment) Act, 2000 whereby clauses (e) and (f) have been inserted. Clause (f) now inserted requires an auditor to comment 'whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of Section 274. The relevant extracts of Section 274(1)(g) referred to in clause (f) of Section 227 (3), are reproduced below:

"274(1) A person shall not be capable of being appointed director of a company, if–

....

....

(g) such person is already a director of a public company which –

(A) has not filed the annual accounts and annual returns for any continuous three financial years commencing on and after the first day of April, 1999; or

(B) has filed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more;

Provided that such person shall not be eligible to be appointed as a director of any other public company for a period of five years from the date on which such public company in which he is a director failed to file annual accounts and annual returns under sub-clause (a) or has failed to repay its deposit or interest or redeem its debentures on due date or pay dividend referred to in clause (B)."

Section 274(1)(g) is applicable to appointment of directors both in public and private companies but the reporting will be limited to those directors of a company who are also directors of any public company. It may be further noted that a person who was a director of a public company which had defaulted in terms of clause (g) of Section 274(1) and ceased to be a director of that public company would not be disqualified from being appointed as a director of a private company since on the date of appointment, he is not director of such public company and moreover proviso to Section 274(1)(g) is only applicable to appointment of such director in another public company.

A person is disqualified from being appointed as a director of a company, where any public company of which also he is a director, has not filed annual accounts and annual returns for any continuous three financial years commencing on and after

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1.4.1999 or has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more. In case of a disqualification by virtue of sub-clause (A) of clause (g) of Section 274(1), the period of five years would be reckoned from the date as specified in sub-clause (A), on which the public company failed to file its annual accounts and annual returns. Where the disqualification arises on account of sub-clause (B) of clause (g) of Section 274(1), the period of five years will be reckoned from the relevant due date as specified in sub-clause (B) for repayment of deposit or interest thereon or redemption of debentures or payment of dividend, as the case may be.

Section 303(1) of the Companies Act, 1956 requires every company to keep a register of directors, etc. at its registered office. The said register contains various particulars relating to all the directors of the company including particulars in respect of the office of director, managing director, etc. held in any other body corporate(s) by each director.

In case an auditee company happens to be a public company which has not filed the annual accounts and annual returns for any continuous three financial years commencing on and after 1st April, 1999; or has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more; then the auditor must report that all the directors are disqualified from being appointed as director in terms of clause (g) of sub-section (1) of Section 274 of the Act.

14. (a) Characteristics of Sampling Errors: SA 530, "Audit Sampling", requires that while evaluating sample results, the auditor should analyse any errors detected in the samples having regard to appropriateness of the audit objective. An auditor while evaluating the errors detected in a sample selected by him from the total audit population, should analyse the nature of the errors, the projected errors in the total population and the sampling risk attached to it. While designing an audit sample, the auditor would also need to define the conditions that constitute the error keeping in view the audit objectives.

Flowing from the above, the auditor, therefore, would also need to consider the qualitative aspects of the errors detected by him. This will include the nature and reasons for the error and its possible effect on other phases. In case a repetitive pattern emerges from such analysis, for example, type of transaction, location, product line or period of time, the auditor would need to identify all items in the population, which contain such errors, resulting in a total population. The auditor would then need to carry out a separate analysis based on the examination carried out by him for each such sub-population. Accordingly, the auditor cannot be satisfied by detecting errors only but also would need to consider the qualitative aspects of such errors.

(b) The Internal Audit Programme in connection with Plant and Machinery and Tools and dies may be on the following lines:

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(i) Internal Control Aspects: The following may be incorporated in the audit programme to check the internal control aspects:

(a) Maintaining separate register for hired assets, leased asset and jointly owned assets.

(b) Maintaining register of fixed asset and reconciling to physical inspection of fixed asset and to nominal ledger.

(c) All movements of assets are accurately recorded.

(d) Authorisation be obtained for – (i) a declaring a fixed asset scrapped, (ii) selling a fixed asset.

(e) Check whether additions to fixed asset register are verified and checked by authorized person.

(f) Proper recording of all additions and disposal.

(g) Examining procedure for the purchase of new fixed assets, including written authority, work order, voucher and other relevant evidence.

(h) Regular review of adequate security arrangements.

(i) Periodic inspection of assets is done or not.

(j) Regular review of insurance cover requirements over fixed assets.

(ii) Assets Register: To review the registers and records of plant, machinery, etc. showing clearly the date of purchase of assets, cost price, location, depreciation charged, etc.

(iii) Cost Report and Journal Register: To review the cost relating to each plant and machinery and to verify items which have been capitalized.

(iv) Code Register: To see that each item of plant and machinery has been given a distinct code number to facilitate identification and verify the maintenance of Code Register.

(v) Physical Verification: To see physical verification has been conducted at frequent intervals.

(vi) Movement Register: To verify (a) whether a Movement Register for movable equipments and (b) log books in case of vehicles, etc. are being maintained property.

(vii) Assets Disposal Register: To review whether assets have been disposed off after proper technical and financial advice and sales/disposal/retirement, etc. of these assets are governed by authorization, sales memos or other appropriate documents.

(viii) Spare Parts Register: To examine the maintenance of a separate register of tools, spare parts for each plant and machinery.

(ix) Review of Maintenance: To scrutinize the programme for an actual periodical

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servicing and overhauling of machines and to examine the extent of utilization of maintenance department services.

(x) Review of Obsolescence: The scrutinise whether expert's opinion have been obtained from time to time to ensure purchase of technically most useful efficient and advanced machinery after a thorough study.

(xi) Review of R&D: To review R&D activity and ascertain the extent of its relevance to the operations of the organisation, maintenance of machinery efficiency and prevention of early obsolescence.

15. (a) Due diligence review of cash flow

(i) Review the historical pattern of cash flows of the organisation and look for change in trends.

(ii) See whether the company is able to meet its cash requirements from internal generations/accruals or does it seek outside sources from time to time.

(iii) Check whether the company honours its commitments to creditors, Government and other stock holders.

(iv) Verify the ability of the company to turn its stock into debtors i.e. sale ability of its products.

(v) Ensure that the company follows up with debtors and that the debtors collection period is not very large.

(vi) Check the ability of the company to deploy its funds in profitable investment opportunities.

(vii) Look into the investment pattern of the company, whether they give maximum benefits to the company and are easily realisable.

(b) In exercise of the powers conferred by clause (a) of sub-section (1) of Section 642 of the Companies Act, 1956 (1 of 1956), read with sub-section (3C) of Section 211 and sub-section (1) of Section 210A of the said Act, the Central Government, in consultation with National Advisory Committee on Accounting Standards, made the Companies (Accounting Standards) Rules, 2006. As per these rules "Small and Medium Sized Company" (SMC) means, a company-

(i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank, financial institution or an insurance company;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

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Explanation: For the purposes of this a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

16. **Matters to be included in Cost Audit Programme:** It is a true statement that like any other audit a systematic planning for cost audit is also necessary. Therefore, the cost audit programme should include all the usual broad steps that a financial auditor includes in his audit programme. This would require that the various aspects like what to be done, when to be done and by whom to be done are adequately takes care of. However, looking to the basic difference in cost audit and financial audit as allocation and apportionment of expenses, statutory requirement etc. should require special consideration. Cost audit, in order to be effective, should be completed at one time as far as practicable. Based on above factors a set of procedures and instructions are evolved which may be termed the cost audit programme. Matters to be included in the Cost Audit Programme may be divided into following two stages:

    (i) Review of cost accounting record: This will include:

    - Method of costing in use
    - Method of accounting for raw material, stores and spares, wastage
    - System of recording wages, salary, etc.
    - Basic of allocation of overheads to cost centres and absorption by product and services
    - Treatment of expenses on finance, R&D, royalty, etc.
    - Method for depreciation accounting
    - Method of stocktaking and valuation
    - System of budgetary control

    (ii) Verification of cost statement and other data: This will mainly cover:

    - Licensed, installed and utilized capacity
    - Operating and financial ratio
    - Production data
    - Consumption of material and actual expenses
    - Sales realisation
    - Abnormal non-recurring and special cost
    - Reconciliation with financial books

    Some other factors which need to be brought into cost audit programme includes system of cost accounting, range of products, areas to be covered etc. indicating allocation of manpower and the time to be taken for computing the audit.

17. (a) **Solvency margin in case of an insurer carrying on general insurance business:** In case of an insurer carrying on general insurance business, the solvency margin should be the highest of the following amounts :

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(i) fifty crore rupees (one hundred crores of rupees in case of reinsurer), or

(ii) a sum equivalent to twenty percent of the net premium income; or

(iii) a sum equivalent to thirty percent of net incurred claims.

Subject to credit for reinsurance in computing net premiums and net incurred claims being actual but a percentage, determined by the regulation but not exceeding fifty percent. It may be noted that conditions regarding maintenance of the above mentioned solvency margin may be relaxed by the authorities in certain special circumstances.

If, at any time, an insurer does not maintain the required solvency margin, the insurer is required to submit a financial plan to the authority indicating the plan of action to correct the deficiency in the solvency margin. If, on consideration of the plan, the authority finds it inadequate the insurer has to modify the financial plan.

Sub-section (2c) of Section 64 A states that if an insurer fails to comply with the requirements of the insurance Act, 1938, it shall deemed to be insolvent and may be wound up by the court.

(b) (i) There is an elaborate framework governing the functioning of banks in India. The whole of banking sector can be categorised into several sectors such as commercial banks, cooperative banks, foreign banks, etc. The principal enactments which govern the functioning of various types of bank are as under:

(a) Bank Regulation Act, 1949;

(b) Banking Companies (Acquisition of Transfer of Undertakings) Act, 1970;

(c) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980;

(d) State Bank of India Act, 1955;

(e) State Bank of India (Subsidiary Banks) Act, 1959

(f) Regional Rural Banks Act, 1976;

(g) Companies Act, 1956; and

(h) Co-operative Societies Act, 1912 or the relevant Sate Cooperative Societies Acts.

Besides, the above enactments, the provisions of Reserve Bank of India Act, 1934, also affect the functioning of banks. The Act gives wide powers to Reserve Bank of India to give directions to Banks; such directions also have considerable effect on the functioning of banks.

(ii) The NEAT system supports an order driven market, wherein order match on the basis of time and price priority. All quantity fields are in units and prices are quoted in Indian Rupees. The regular lot size and tick size for various securities traded is notified by the Exchange from time to time.

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Market Types: The Capital Market system has four types of market:

- Normal Market: Normal market consists of various book types wherein orders are segregated as Regular Lot Orders, Special Term Orders, Negotiated Trade Orders and Stop Loss Orders depending on their order attributes.
- Odd Lot Market: The odd lot market facility is used for the Limited Physical Market.
- RETDEBT Market: The RETDEBT market facility on the NEAT system of capital market segment is used for transactions in Retail Debt Market session. Trading in Retail Detail Market takes place in the same manner as in equities (capital market) segment.
- Auction Market: In the Auction market, auctions are initiated by the Exchange on behalf of trading members for settlement related reasons.

18. (a) Clause 4D of Part II of Schedule VI to the Companies Act, 1956 requires that the profit and loss account should contain by way of a note the following information:

a. Value of imports (c.i.f. basis) by the company during the financial year of :

(i) Raw materials

(ii) Components and spare parts

(iii) Capital goods

b. Expenditure in foreign currency during the financial year on account of :

(i) Royalty

(ii) Know-how

(iii) Professional consultation fees

(iv) Interest

(v) Others

c. (i) Value of all imported raw materials, stores and components consumed during the financial year.

(ii) Value of all indigenous raw materials, stores and components consumed during the financial year.

(iii) The percentage of each of total consumption

d. (i) Dividends remitted during the year in foreign currencies

(ii) Number of non-resident shareholders

(iii) Number of shares held by non-resident shareholders

(iv) Year to which dividends related

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e. Foreign exchange earnings to be classified under the following heads namely:

(i) Export of goods (FOB basis)

(ii) Royalty

(iii) Know-how

(iv) Professional consultation fees

(v) Interest

(vi) Dividends

(vii) Others

(b) As per Section 293 (1) (e) of the Companies Act, 1956, the Board of Directors of a Public Ltd. Co. have to obtain the consent of the company in general meeting if they wish to contribute to charitable and other funds not directly relating to the business of the company or the welfare of its employees, any amounts the aggregate of which will, in any financial year, exceed fifty thousand rupees or five 350 during the three financial years immediately preceding, whichever is greater. In the given case, the two donations given by the company are not directly relating to business of the company or the welfare of its employees. In the case, the Board of directors can contribute either (i) Rs.50,000 or (ii) 5% of average net profit of least 3 financial years i.e. Rs.60,000 which ever is greater. Therefore Board of Directors can contribute maximum of Rs.60,000 to both charitable institutions without the consent of the company in general meeting. The action of Board of directors has violated Section 293 (1) (e) of the Companies Act, and this matter should be reported in the auditor's report.

(c) In vouching payments, the auditor does not merely check that money has been paid away. Apart from checking that money has actually been paid (and fictitious payments are not shown in records), the auditor pays attention to the following:-

(a) The payment has been sanctioned by a competent person.

(b) It is not ultra vires the entity.

(c) It pertains to the entity i.e. it is a business payment and not a personal expense.

(d) The goods/services/value which should have been received, have been received by the business.

(e) The payment has been made during the period under audit.

(f) The payment has been correctly accounted for making proper classification between capital and revenue.

(g) The payment has been correctly accounted for making proper classification between capital and revenue.

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In Thomas v. Devonport Corporation (1900) 1 QB 16 Lord Russel of Killowen C.J. held that auditor's duty is not confined to seeing whether there are vouchers, apparently formal and regular, justifying each of the items in the accounts under audit. An auditor is entitled, justified and bound to go further than that. By fair and reasonable examination of the vouchers, he should "see that there are not amongst the payments so made payments which are not authorised by the duty of the authority, or contrary to the duty of the authority, or in any other way illegal or improper".

19. (a) CARO, 2003 requires companies to which it applies to physically verify inventories at reasonable intervals and also to maintain inventory records. Further, any material discrepancies between the physical stock and book records is required to be properly dealt with in the books of account. CARO, 2003 requires the auditor to report whether the company is complying with these requirements or not. Even if CARO, 2003 is not applicable, company cannot dispense with physical stock-taking. Who can guarantee that the security agencies are doing their job in a fool-proof manner. After all, they are also human beings. Physical stock-taking is an essential ingredient of any internal control system. Therefore, the company's contentions cannot be accepted.

(b) Mr. Z's contention is unacceptable. According to Section 228 of the Companies Act, 1956, a company can appoint as auditor of a foreign branch an accountant duly qualified to act as an auditor in accordance with the laws of the foreign country. Mr. Z has a statutory right to visit any branch. According to Section 228, if the accounts of any branch office are audited by a person other than the company's auditor, the company's auditor shall have the following rights –

- to visit the branch office if he considers necessary for performance of duties as auditor; and
- access at all times to books and vouchers maintained at the branch office.

(c) According to Section 228(3) (a), where a company in general meeting decides to have the accounts of a branch audited otherwise than by the company's auditor, the company in that meeting shall do either of the following two things -

(a) appoint a person qualified for appointment as auditor of the company under Section 226, or if the branch is situated outside India, a person qualified under Section 226 or an accountant duly qualified to be auditor under the laws of that country, or

(b) authorise the Board of Directors to appoint such a person in consultation with the company's auditor.

So, it is clear that if the company itself appoints the branch auditor in general meeting there is no need for consultation with the statutory auditor (as is the case in the present problem). The need for consultation with company's auditor arises only when the Board of Directors appoint the branch auditor in pursuance of the

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meeting's authorisation under Section 228(3) (a). In that case, the Board of Directors should appoint the branch auditor in consultation with the company's auditor.

20. (a) 1. Yes. These bottles are "assets" of the company. An asset is a resource controlled (not necessarily "owned" – Control does not necessarily mean "legal ownership") by an enterprise as a result of past events from which future economic benefits to the enterprise are expected. In assessing whether an item meets the above definition of "assets", the consideration should be given to economic reality and substance and not merely legal form by leaving the bottles behind, the customers can be said to be regarded as "assets" of the company.

2. The stock of empty bottles is "inventory" as the company holds them for sale in the ordinary course of its business of running the bars.

3. These bottles should be valued at the lower of cost and net realisable value. However, the cost of purchase and selling price of beer / IMFL are both inclusive of cost of bottles as beer / IMFL cannot be sold without bottles – the primary packing. Practically, the empty bottles do not appear to cost anything to the company (i.e. zero cost), if that be the case, the bottles should be reflected at nominal value of Re.1.

4. It would not be correct to value the bottles at net realisable value with credit being given to "income" as the bottles have not been sold at the balance sheet date.

(b) The Supreme Court explained this in Reliance Energy Limited v. Maharashtra State Road Development Corporation Ltd. [Appeal (civil) 3526 of 2007, Judgment dated 11-9-2007). When P&L accounts and balance sheets are prepared on accrual basis, revenues and expenses are recognised on accrual basis, i.e., when the transaction or event occurs. However, timing of cash flow is not reckoned in such system of accounting. Similarly, in cases where accounts are based on accrual system of accounting, recognition of assets and liabilities is not dependent on the actual timing of cash spent on capital expenditure and cash inflow on account of capital receipt. Thus the financial statements prepared on accrual basis do not reflect the timing of the cash flow and amount of cash flow. The object of the cash flow statement is to assess the company's ability to generate the cash flow in future and to assess reasons for difference between "net profit" and "net cash flow" from operations.

In fact net cash flow from operations is the regular source of cash in any enterprise that determines whether or not an enterprise will continue to exist in the long run. Accrual basis of accounting requires that revenues be recorded when earned and the expenses be recorded when incurred. Earned revenues more often include credit sales that have not been collected in cash and expenses incurred that may not have been paid in cash during the accounting period. Thus net income will not indicate the net cash provided by operating activities or net loss will not indicate the

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net cash used in operating activities. In order to calculate the net cash provided by (or used in) operating activities, it is necessary to replace revenues and expenses on accrual basis with actual receipts and actual payments in cash. This is done by eliminating the non-cash revenues and non-cash expenses from the given earned revenues and incurred expenses in the profit and loss account. The profit and loss account is also debited and credited with purely non-cash items which reduce and increase the profits respectively but do not affect the cash at all e.g. depreciation, loss (or profit) on the sale of fixed assets, amortisation of intangible assets like goodwill, patents trademarks etc. deferred revenue expenditures like preliminary expenses, discount on the issue of shares and debentures and so on. Since cash provided by operations is to be calculated, certain non-operation items like rent income, interest income, dividend income, refund of tax etc. should also be adjusted although these items may have been recorded on cash basis. Such items are analysed separately in the cash flow statement as operating, investing and investing activities.

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