PAPER – 3 : ADVANCED AUDITING

Answer Question Nos. 1 and 2 and four from the rest.

Question 1

1. As a Statutory Auditor, how would you deal with the following:

   (a) While adopting the accounts for the year, the Board of Directors of Sunrise Ltd. decided to consider the Interim Dividend declared @15% as final dividend and did not consider transfer of Profit to reserves. (4 Marks)

   (b) V Ltd. sold 1 lakh vacuum pumps during the year 2006-07 with a condition to make good by repair/replacement any manufacturing defects reported within 6 months from the date of sale. Past experience in this regard showed that there were no replacements carried out, but minor/major repairs were necessitated to the extent of 10%/5% respectively of the units sold. The cost of such minor/major repairs would amount to Rs. 1,000/Rs. 6,000 respectively. While finalizing the accounts for the year, the company does not reflect any provision, in this regard. (5 Marks)

   (c) XYZ Pvt. Ltd., manufacturing garments, has valued at the year end its closing stock of packed finished goods for which firm export contracts have been received, at realizable value inclusive of profit and export cash incentive. As at the year end, the ownership of the goods has not been transferred to the foreign buyers. (4 Marks)

   (d) R Ltd. owns 51% voting power in S Ltd. It however holds and discloses all the shares as "Stock-in-trade" in its accounts. The shares are held exclusively with a view to their subsequent disposal in the near future. R Ltd. represents that while preparing Consolidated Financial Statements, S Ltd. can be excluded from the consolidation. (5 Marks)

Answer

(a) Declaration of Interim Dividend: Section 205 (1A) of the Companies Act, 1956 provides that Board of Director may declare interim dividend and the amount of dividend including interim dividend should be deposited in a separate bank account within five days from the declaration of such dividend.

Based on Section 2(14A) read with Section 205(1C) of the Companies Act 1956, it can be said that since interim dividend is also dividend, companies should provide for depreciation as required by Section 205 and comply with the companies (Transfer of Profit to Reserve Rules, 1975) before declaration of interim dividend. As per Companies (Transfer of Profit to Reserve) Rules, 1975, where the dividend proposed exceeds 12.5 per cent but does not exceed 15 per cent of the paid-up capital, the amount to be transferred to the reserves shall not be less than 5 per cent of the current profits . The company has to provide depreciation for the full year before declaration of interim dividend. If the company does not transfer any profit to reserves, it can pay interim dividend not exceeding 10% of the paid up capital. In the instant case, the Board has decided to pay interim dividend @15% of the paid-up capital without transfer of profit to reserves. Assuming that the company has complied with depreciation requirement, the interim dividend should be restricted to 10% without transfer of profit to reserves.

In the circumstances, the Board of Directors are wrong in declaring interim dividend at 15 %, though such dividend can be treated as final dividend. The statutory auditor should qualify his report.

(b) Provisions: As per AS – 29, 'Provisions, Contingent Liabilities and Contingent Assets', a provision is a liability which can be measured only by using a substantial degree of estimation.

As per AS – 29 , a provision should be recognised when:

1. An enterprise has a present obligation as a result of a past event.
2. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and
3. A reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

In the present case, V Ltd fulfils all the above conditions. The sale of pumps with a warranty obligation constitutes the present obligation as a result of past event. It is probable that some outflow will be involved in setting the warranty obligation, satisfy the second condition. As per the details based on past precedence reliable estimate can be made as under:

[6000 × (5% of 100000) + 1000 × (10% of 100000)] = Rs. 400 lakhs

Thus, V Ltd as on 31.3.07 should make a provision for warranty obligation against sale of vacuum pumps to the extent of rupees 400 lakhs. The auditor should insist on such provision being created. If provision is not made he should qualify his audit report.

(c) Valuation of Inventories: AS 2 requires that inventories should be valued as lower of cost and Net realisable value(NRV). A departure from the general principle can be made if the AS is not applicable or having regard to the nature of industry.

AS 2 also states that (a) work in progress arising under construction contracts,including directly related service contracts (b) work in progress arising in the ordinary course of business of service providers;(c) shares, debentures and other financial instruments held as stock-in-trade; and(d) producers' inventories of livestock, agricultural and forest products are measured as NRV based on established practices.

In the given case the sale is assumed under a forward contract but the goods are not of a nature covered by the above exceptions Taking into account the facts the closing stock of finished goods should have been valued at cost, as it is lower than the realisable value (as it includes profit). Further, export cash incentives should not be included for valuation purposes.

The policy adopted by the company for valuing its closing stock of inventory of finished goods on selling price plus export incentives is not correct. The statutory auditor should give a qualified report.

(d) Consolidation of Financial Statement: AS 21 states that a subsidiary should be excluded from consolidation when:

1. Control is intended to be temporary because the shares are acquired and held exclusively with a view to its subsequent disposal in the near future or
2. Subsidiary operates under severe long term restrictions which significantly impair its ability to transfer funds to the parent.

Where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and all the shares held as 'stock-in-trade' are acquired and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise would be considered temporary.

In this case, R Ltd's intention is to dispose off the shares in the near future as shares are being held as stock in trade and it is quite clear that the control is temporary.

Hence, in this case the exclusion of the concerned subsidiary from consolidation is correct.

However, reasons for not consolidating a subsidiary should be disclosed in the consolidated financial statements.

If an entity is excluded from the consolidated financial statements for reasons other than those allowed by the above AS, the auditor should consider the effect on the report to be issued.

Question 2

Comment on the following with reference to the Chartered Accountants Act, 1949 as amended by the Chartered Accountants (Amendment) Act, 2006 and schedules thereto:

(a) As a Chartered Accountant in practice, you are asked to conduct a review of the "Profit Forecast" prepared by a Company in connection with its application for a Term loans from a bank. (4 Marks)

(b) X, a Chartered Accountant availed a loan against his shares held as investments from a nationalized bank. He issued 2 cheques towards repayment of the said loan. Both the cheques were returned back by the bank with the remarks "Refer to Drawer". (5 Marks)

(c) BC & Co, a firm of Chartered Accountants, accepted an assignment for audit under State level VAT Act, without any prior communication with the previous auditor. (4 Marks)

(d) M, a Chartered Accountant in practice, is the Statutory Auditor of S Ltd. for the year ended 31st March 2008. In January 2008, he was appointed as a Director in H Ltd., which is the holding Company of S Ltd. (5 Marks)

Answer

(a) Under Clause 3 of Part I of Second Schedule to The Chartered Accountants Act, 1949, a CA in practice is deemed to be guilty of professional misconduct if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast. "The guidance note on accountants' report on profit/financial forecast" provides that profit forecasts can be prepared or reviewed by a CA provided he discloses in his report the sources of information, the basis of forecasts and major assumptions involved and so long as he does not vouch for the accuracy of the forecast. Hence, the offer can be accepted if the above guidance note is complied with.

(b) A Chartered Accountant is expected to maintain the highest standard of integrity even in his personal affairs and any deviation from these standards, even in his non-professional work would expose him to disciplinary action.

A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, if he is found guilty of any professional or "Other Misconduct".

As per part IV of the First Schedule to the Chartered Accountants Act, A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he in the opinion of the Council, brings disrepute to the profession or the Institute as a result of his action whether or not related to his professional work.

The question whether a particular act or omission constitutes "other misconduct" should be based on fact and circumstances of each case.

Under Negotiable Instruments Act 1881, where any cheque drawn by a person for the discharge of any liability, is returned by the bank unpaid, either for insufficiency of funds or the cheque amount exceeds the arrangements made by the drawer of the cheque, the drawer of such cheque shall be deemed to have committed an offence.

In the given case the cheque was dishonoured with the remark "refer to drawer". However, such dishonour need not necessarily be only due to insufficiency of funds.

If it is proved that the cheques were dishonoured due to insufficiency of funds, the CA would be held guilty of "other misconduct".

(c) As per Clause 8 of Part I of First Schedule to the CA Act 1949, A chartered accountant in practice is deemed to be guilty of professional misconduct if he accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been issued certificate under the Restricted Certificates Rules 1932, without first communicating with him in writing.

In the instant case, BC & Co. accepted VAT – audit under State Level Act, carried out by another firm of chartered accountants in the previous year, without prior communication with the previous auditor.

A communication is mandatory requirement for all types of audit, if the previous auditor is a chartered accountant. Hence, the firm is guilty of professional misconduct.

(d) In terms of clause 11 of Part I of the First Schedule to the CA Act, 1949, a CA in practice cannot engage (unless permitted by the council) in any business or occupation other than the profession of Chartered accountant, but he can be a director of a company wherein he or any of his partners is not interested in such company as auditor.

However, public conscience is expected to be ahead of law and the requirement of independence should be interpreted much more strictly. Members should thus not place themselves in position which would either compromise or jeopardise their independence.

In view of the above, an auditor of a subsidiary cannot be a director of a holding company as it will affect his independence.

Question 3

Answer the following:

(a) "Use of Audit Software would increase the probability of detecting frauds". Comment. (6 Marks)

(b) Elaborate under Clause 49 of the Listing Agreement, who is an Independent Director. (6 Marks)

(c) What is an Audit Trail? (4 Marks)

Answer

(a) Use of Audit Software: CAATs allow the auditor to give access to data without dependence on the client, test the reliability of client software and perform audit tests more efficiently. CAATs are used to perform various audit procedures like;

(i) Tests of details of transactions and balances e.g. use of audits software to test all or a few transactions in a computer file.

(ii) Analytical review procedures e.g. use of audit software to identify unusual fluctuations or items.

(iii) Compliance tests of IT application controls e.g. use of test data to test the functioning of a programmed procedure.

However, the methods of applying audit procedures to gather evidence may be influenced by the methods of computer processing. Sometimes, in some accounting systems that use of computer for processing significant applications, it may difficult or impossible for an auditor to obtain certain data for inspection, inquiry or confirmation without computer assistance.

CAAT in fraud Detection: In an EDP environment, the Auditor is required to plan his work by exercising reasonable care and skill in such a manner that there is reasonable expectation of detecting material misstatements in the financial information resulting from fraud or error.

Use of the CAAT/ audit software systems will help the auditor to identify errors and frauds in the accounting and internal control system.

Conclusion: Frauds are intentional. Auditing through the computer with adequate knowledge of computer systems may highlight some frauds, but there is no empirical evidence to prove the assertion that the use of audit software systems has unearthed well concealed frauds.

Thus, it cannot be conclusively said that use of audit software systems increases the probability of detection of fraud.

(b) Clause 49 of the listing agreement on Independent Director: As per Clause 49 of the listing agreement, an Independent Director shall mean a non-executive director of the company who:

(i) apart from receiving director's remuneration, does not have any material pecuniary relationship or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiary(s) and associates which may affect independence of the director;

(ii) is not related to promoters or persons occupying management positions at the board level or at one level below the Board;

(iii) has not been an executive of the company in the immediately preceding three financial years;

(iv) is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:

(a) The statutory audit firm or the internal audit firm that is associated with the company, and

(b) The legal firm(s) and consulting firm(s) that have a material association with the company.

(v) is not a material supplier, service provider or customer or a lessor or lessee of the company which may affect independence of the director and

(vi) is not a substantial shareholder of the company i.e. owning two per cent or more of the block of voting shares.

(c) Audit Trail: Audit Trail can be defined as those documents, records, journals, ledgers, master files etc. that enables an auditor to trace the transactions from the source document to the summarised total in accounting reports or vice-versa.

Audit trail is the visible means whereby the auditor may have a business transactions through all the stages in which it features in the records of the business. For example, sequentially numbered sales invoice copies would normally be listed in a register or day book and subsequently filed either in numerical or chronological sequence. It would then be possible to trace a particular invoice from the day book to the original file or vice-versa by reference to the number or date of the invoice.

In a manual accounting system, it is possible to relate the recoding of a transaction at each successive stage enabling an auditor to locate and identity all documents from beginning to end for the purposes of examining documents, totalling and cross-totalling referencing.

However, in an EDP environment, the use of exception reporting by management has effectively eliminated the audit trail between input and output. Frequently computer generated totals, analysis and balances are not printed out in detail because the management is not exercising control through verification of the individual items processed.

Question 4

Answer the following:

(a) What are the major differences between Financial and Operational Auditing? (8 Marks)

(b) As a Statutory Auditor, how would you deal with the following :

(i) PQR Ltd. has not deposited Provident Fund contribution of Rs. 10 lakhs with the authorities till the year-end. (4 Marks)

(ii) LM Ltd. had obtained a Term Loan of Rs. 300 lakhs from a bank for the construction of a factory. Since there was a delay in the construction activities, the said funds were temporarily invested in short term deposits. (4 Marks)

Answer

(a) The major differences between financial and operational auditing can be described as follows:

(i) Purpose: The financial auditing is basically concerned with the opinion that whether the historical information recorded is correct or not, whereas the operational auditing emphasizes on effectiveness and efficiency of operations for future performance.

(ii) Area: Financial audits are restricted to the matters directly affecting the appropriateness of the presented financial statements whereas the operational audit covers all the activities that are related to efficiency and effectiveness of operations directed towards accomplishment of objectives of organisation.

(iii) Reporting: The financial audit report is sent to all stock holders, bankers and other persons having interest in the organisation. However, the operational audit report is primarily for the management.

(iv) End task :The financial audit has reporting the findings to the persons getting the repost as its end objectives, however, the operational audit is not limited to the reporting only, but includes suggestions for improvements also.

The main objective of operational auditing is to verify the fulfillment of plans, and sound business requirements. Operational auditing is considered as specialized management information tool. Operational auditing is essentially a function of internal auditing staff. Operational auditing is a systematic process of evaluating an organisation's effectiveness, efficiency and economy of operations under management control and reporting to appropriate persons, the result of the evaluation alongwith recommendations for improvements. Operational audit concentrates on effectiveness, efficiency and economy of operations and therefore it is future oriented. It does not end with the reporting of the findings but also recommends the steps for improvements in future. Operational auditing is not different from internal auditing, it is merely an extension of internal auditing into operational areas.

While in financial auditing, the concentration is more in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are minimized or removed. In financial auditing, an auditor is called upon to review the financial statements of an enterprise to ascertain whether they reflect true and fair view of its state of affairs and of its working results. He may analyse the operations of an enterprise to appraise their cost effectiveness and also he may seek evidence to review the managerial performances.

(b) (i) Under Clause 4 (ix) (a) of CARO, 2003 the auditor has to report on the regularity of depositing undisputed statutory dues including provident fund with the appropriate authority and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.

It should be accounted in the books on accrual basis whether paid or not. As per Sec. 209 (3) of the companies Act, a company has to maintain proper books of account on accrual basis of accounting.

In the instant case, even though accrual principles have been followed, disclosure of non-payment is necessary in view of CARO requirements. The auditor should disclose the fact of non-payment of Rs. 10 lakhs in his report.

(ii) As per paragraph 4(xvi) of CARO, 2003, an auditor need to comment "whether the term loans applied for the purpose for which the loan were obtained".

In the present case, the term loan obtained by LM Ltd. have not been put to use for construction activities and temporarily invested the same in short term deposit.

Here, the auditor should report the fact in his report that pending utilization of the term loan for construction of a factory, the funds were temporarily used for the purpose other than the purpose for which the loan was sanctioned, as per paragraph 4(xvi) of CARO, 2003.

Question 5

Answer the following:

(a) As a Statutory Auditor, how would you verify advances against Goods? (8 Marks)

(b) Explain the concept of Audit risk:

(i) At the level of financial statements (4 Marks)

(ii) At the level of account balance and class of transactions. (4 Marks)

Answer

(a) Verification of advances against goods(Banking Companies):

(i) Sanction: Examine the sanction letter, letter of hypothecation and note the important terms and conditions of the advances.

(ii) Stock statements: Verify the quantity and value of goods hypothecated based on the stock statements received from the borrower. Test check the Godown Register and examine the valuation of goods to ascertain the reasonableness of the same.

(iii) Inspection: Ascertain as to whether the premises of the borrowers are periodically visited by the bank officials to verify the quantity as per the periodic stock statements.

(iv) Stock Audit: See whether the bank has got a system of obtaining stock and receivables audit report in respect of such advances. If so, review the stock audit report and identify adverse comments, if any.

(v) Hypothecation/Pledge: Examine the letter of hytothecation and certificate of registration of charge, in respect of goods pledged with the bank.

(vi) Insurance: Examine the insurance policies for their validity, adequacy etc. and see that policies are in favour of the bank.

(vii) Documents of title: Inspect the documents of title to goods like bill of lading, dock warrant, railway receipts etc to ensure that they are endorsed registered in favour of the bank.

(viii) Third party certificate: Where the hypothecated goods are in possession of third parties, such as clearing and forwarding agents, transporters, bankers, etc. undertaking has been obtained by the bank that they will handover the goods or sale proceeds thereof to the bank only. In such cases, certificate should be obtained by the bank from such third parties regarding quantities on hand, on balance sheet date. The valuation of such goods should be checked by the auditor.

(b) (i) Audit risk at the financial statement level: Audit risk is considered at the financial statement level during the audit planning process. At this time, the auditor should undertake an overall audit risk assessment based on his knowledge of the client's business, industry, management, control environment and operations. Such an assessment provides preliminary information about the general approach to the engagement, the auditor's staffing needs and the framework within which materiality and audit risk assessment can be made at the individual account balances or class of transactions level. For assessing inherent risk, the auditor uses professional judgement to evaluate numerous factors, examples of which are:

- The integrity of management
- Management experience, knowledge and changes during the period (e.g. the inexperience of management may affect the preparation of the financial statements of the entity)
- Unusual pressure on management
- The nature of entity's business (e.g. its technological obsolescence of products and services, complex capital structure, significance of related parties and the number of locations and geographical spread of its production (facilities), factors affecting the industry in which the entity operates (e.g. economic and competitive conditions, changes in technology).

(ii) Audit risk at the account balance and class of transactions level: Majority of audit procedures are directed to, and carried out at the account balance and class of transactions level. Accordingly, audit risk should be considered by the auditor at this level taking into account the results of the overall audit risk assessment made at the financial statement level. To assess inherent risk, the auditor uses professional judgement to evaluate numerous factors, examples of which are:

(i) The complexity of underlying transactions which might require the use of the work of an expert;

(ii) Susceptibility of assets to loss or misappropriation;

(iii) The completion of unusual and complex transactions, particularly at or next year end, and

(iv) Transactions not subjected to the normal processing mode.

Question 6

Answer the following:

(a) RQ Insurance Ltd. has made a provision of 25% on unexpired risks reserve in its books. Comment. (5 Marks)

(b) In the context of Audit of members of Stock Exchanges, explain what is Rolling Settlement? (5 Marks)

(c) What is Haphazard Sampling? (6 Marks)

Answer

(a) Unexpired risks reserve: The need for unexpired risks reserve arises from the fact that all policies are renewed annually except in specific cases where short period policies are issued. Since the insurers close their accounts on a particular date, not all risks under policies expire on that date.

In other words at the closing date, thee is an unexpired liability under various policies which may occur during the remaining term of the policy beyond the year end.

The minimum amount of unexpired risks reserve to be created is determined as per the Insurance Act, 1938 at a specified percentage of net premium as under:

(i) for marine hull insurance – 100% of net premium

(ii) For fire, marine cargo and miscellaneous business – 50% of net premium.

Provisions of income Tax Act 1961 and Income Tax rules 1962 permit deduction of above reserves at the prescribed rates.

Conclusion: In the given case, the Auditor of RQ Insurance Ltd should qualify his report as the company has made a provision of only 25% against the prescribed minimum of 50% or 100% as mentioned above, thereby resulting in overstatement of profit.

(b) Rolling settlement: A rolling settlement is one in which trades outstanding at the end of the day have to be settled (payments made for purchases or deliveries in the case of sale of securities) within 'X' business days from the transaction date.

In the rolling settlement, trades on each single day are settled separately from the trades done earlier or subsequent trade days. The netting of trades is done only for the day and not for multiple days.

SEBI has gradually mandated most of the scrips to be settled exclusively on Rolling Settlement basis [t +2]. Thus, in a T+2 rolling settlement, a transaction entered into on Monday, for instance, will be settled on Wednesday when the pay-in or pay-out takes place. The transaction in the Compulsory Rolling Settlement (CRS) are settled on T+2 basis i.e. both pay in and pay out of monies and securities for transactions in scrips on transaction day (T-Day) would take place on the day after immediately following day.

However, transactions in 'Z' group securities are settled only on trade to trade basis on T+2, i.e. the facility of netting up of buy and sell transactions of the same day, as available in other securities, is not available with securities falling under 'Z' group. In other words, if the investor buys and sells X number of shares on the same day , then he shall first have to actually deliver and then receive the securities on the settlement day.

Value at Risk (VaR) based margining approach has been adopted for transactions done in CRS scrips w.e.f. July 2, 2001. In the VaR system of margining, historical volatilities of scrips and overall market volatility is considered to arrive at a VaR margin percentage for a scrip. Further the mark-to-market difference are collected on a daily basis and the broker members are required to maintain a capital level, as prescribed by the exchange, adequate to support their exposure at all times.

In case, a member fails to deliver the shares sold in rolling settlement, the exchange conducts an auction session on T+2, to meet the shortfall created by non-delivery of shares. In this auction session, offers are invited from the other members to deliver the shares sold by originally selling member, since delivery has to be made to the buying member. In case no shares are received in auction, the sale transaction is closed-out at a close-out price, determined by higher of the following:

- Highest price, recorded in the scrip from the settlement in which the transaction took place upto a day prior to the auction OR
- 20% above the closing price on a day prior to the auction.

In this case, the auction price/ close-out and difference between sale price, if positive is payable by the seller who failed to deliver the scrips. In case, auction/ close out price is less than sale price, the difference is not given to the seller, but is credited to investor protection fund.

(c) Haphazard Sampling: In haphazard selection, the auditor selects the sample without following a structured technique .Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

Haphazard selection of sample, may be an acceptable alternative to random selection of sample, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units.

When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily located, as they may not be representative.

Question 7

Answer the following:

(a) What are the areas in which Due Diligence can take place ? (5 Marks)

(b) What are the steps to be taken by a firm of Chartered Accountant to ensure that its appointment as Statutory Auditor of a Company is valid? (6 Marks)

(c) As the tax auditor of a Company, how would you report on payments exceeding Rs 20,000 made in cash to a supplier against an invoice for expenses booked in an earlier year? (5 Marks)

Answer

(a) Areas in which Due Diligence can take place :

1. Commercial/operational due diligence: It is generally performed by the concerned acquire enterprise involving an evaluation from commercial, strategic and operational perspectives. For example, whether proposed merger would create operational synergies.
2. Financial Due Diligence: It involves analysis of the books of accounts and other information pertaining to financial matters of the entity. It should be performed after completion of commercial due diligence.
3. Tax Due diligence: It is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence .The accountant has to look at the tax affect of the merger or acquisition.
4. Information systems due diligence: It pertains to all computer systems and related matter of the entity.
5. Legal due diligence: This may be required where legal aspects of functioning of the entity are reviewed. For example, the legal aspects of property owned by the entity or compliance with various statutory requirements under various laws.
6. Environmental due diligence: It is carried out in order to study the entity's environment, its flexibility and adaptiveness to the acquirer entity.
7. Personnel due diligence: It is carried out to ascertain that the entity's personnel policies are in line or can be changed to suit the requirements of the restructuring.

(b) Validity of appointment as a statutory auditor: To ensure that the appointment is valid, the incoming auditor should take the following steps before accepting his appointment:

1. Ceiling limit: Ensure that a certificate has been issued u/s 224 of the Companies Act, so that the total number of company audits held by the firm (including the new appointment) will not exceed the specified number.
2. Resolution at AGM: Verify that at AGM of the Company, a proper resolution is passed. Inspect general meeting minutes book to see that the appointment is duly recorded.

3. Compliance with law: Satisfy that the legal procedure contemplated in section 224 and 225 of the Companies Act, dealing with removal of existing auditor, if required, has been followed. Also see whether section 224A (provision of special resolution in case of companies in which not less than 25% of the subscribed capital of the Company is held by public financial institutions or Government Companies) and section 619B (in case of a company in which not less than 51 % of the paid up share capital is held by Central / State Government - C&AG appointment) are attracted and complied with..
4. Code of conduct: Communicate with the previous auditor, if any, to ascertain if there are any professional reasons for not accepting the appointment.

(c) Reporting of payments exceeding Rs. 20000 in cash: Such reporting is required to be done while conducting the tax audit u/s 44AB of the Income Tax Act, 1961 in Form 3CD with effect from A. Y. 2008-09. The tax auditor shall have to report for clause 17 (h) for the above as per the amended section 40 A(3) of the Income Tax Act, 1961.

In the instant case the invoice for expenses has been booked in an earlier year. However, since payment for the same is made during the current year by cash exceeding Rs. 20000, the reporting thereof would be necessary in clause 17(h) of Form 3CD. The sub-clause (h) required furnishing of the amount inadmissible under section 40A(3) read with rule 6 DD along with computation.

The entire amount paid as above, is likely to be disallowed u/s 40 A(3) of the Income Tax Act, 1961.

Question 8

Write short notes on any four of the following:

(a) Securities Transaction Tax

(b) Price/Earnings (P/E) ratio

(c) Key Management Personnel

(d) Normal Capacity for the purpose of Inventory valuation

(e) Integral Foreign Operations

(f) Emphasis of matter paragraph in Audit Reports (4 X 4 = 16 Marks)

Answer

(a) Security Transaction Tax (STT): In the union budget for 2004-05, Government has introduced Security Transaction Tax to be levied on all transactions done on stock exchanges. As per the provisions of the Finance Bill the stock exchanges have been entrusted with the responsibility of levy, collection and remittance of the STT on all transactions from the date of notification by the Government of India.

SEBI vide its Circular no. MRD / DOP /Cir – 28 / 2004 dated August 23, 2004 directed that no stock exchange shall permit trading activities unless it implements necessary software and procedures for the levy, collection and remittance of STT.

(b) Price/Earning Ratio: The pre-issue price/earning ratio should be calculated by using the following formula:

Issue price per share / EPS

The issue price per share which is to be used for computing this ratio (and not the market price per share which is normally used for computation of the price/earning ratio).

Accordingly, for this purpose issue price per share is required to be used. However, P/E ratio of the company based on issue price is to be compared with the industry P/E ratio, based on market price. For the purpose of the industry P/E ratio, the auditor should check that the market price should be the market price for the industry prevailing within one month prior to the date of auditor's report or as close thereto as possible.

(c) Key management personnel: Key management personnel are those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

It may be noted here that non-executive directors of a company will not be considered as key management personnel under AS 18 by virtue of merely their being directors, unless they have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

Further, the requirements of AS 18 should not be applied in respect of a non-executive director even if he participates in the financial and/or operating policy decision of the enterprise unless he falls in any of the categories discussed in Accounting Standard Interpretation 21.

(d) Normal capacity for inventory valuation: As per AS 2, allocations of fixed production overheads for the purpose of there inclusion in the costs of conversion is based on the normal capacity of the production facilities.

Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. Due to this, the fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. In periods of high production, these overheads allocated are decreased so that inventories are not measured above cost.

(e) Integral Foreign Operations: As per AS 11, there are foreign operations, the activities of which are an integral part of the reporting enterprise. This is important since the method used to translate financial results of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise.

A foreign operation that is integral to the operation of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. In such cases, change in exchange rates between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rates affects the individual monetary items held by the foreign operation rather than the net investment in that operation.

(f) Emphasis of matter paragraph in audit reports: An auditor's report can be modified for matters that do not affect the auditor's opinion. An "emphasis of matter" paragraph is such a type of notification in an audit report. In certain circumstances, such a paragraph is added to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such a paragraph does not affect the auditor's opinion. Such a paragraph is preferably included preceding the opinion paragraph and would ordinarily refer to fact that the auditor's opinion is not quantified in this respect. (AAS 28).

An illustration of an emphasis of matter paragraph for a significant uncertainty in an auditor report is as follows :

"Without qualifying our opinion, we draw attention to Note X of schedule to the financial statements. The entity is the defendant in a lawsuit alleging infringement of certain patent right and claiming royalties and punitive damages. The entity has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate of the matter can not presently be determined, and no provision for any liability, that may result, has been made in the financial statements."